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No. 04-

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Through passage of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA"), Congress, *inter alia*, amended Section 28 of the Securities Exchange Act of 1934 to preempt any private action brought on behalf of 50 or more persons from proceeding under the statutory or common law of any State in any state or federal court if such action alleges "[a] misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A), (5)(B).

In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), this Court adopted a "purchaser-seller" standing limitation in private actions brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), by requiring the private plaintiff to be an actual purchaser or seller. The decision below implicates whether that judicially crafted "purchaser-seller" standing requirement articulated as a limit on private fraud actions under Section 10(b) applies to limit SLUSA's broad preemptive scope over state law claims.

The question presented in this petition is:

Whether, as the Seventh Circuit held earlier this month and in direct conflict with the decision below, SLUSA preempts state law class action claims based upon allegedly fraudulent statements or omissions brought solely on behalf of persons who were induced thereby to hold or retain (and not purchase or sell) securities?

STATEMENT PURSUANT TO RULE 29.6

Petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated is wholly owned by Merrill Lynch & Co., Inc. Merrill Lynch & Co., Inc. is a publicly held company whose shares are traded on the New York Stock Exchange.

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Petitioner respectfully prays that a writ of *certiorari* issue to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The order of the district court (Pollack, J.) granting petitioner's motion to dismiss the first amended complaint with prejudice is reported at 2003 U.S. Dist. LEXIS 5999 (S.D.N.Y. Apr. 10, 2003) and is reprinted in the Appendix ("Pet. App.") at 53a-55a. The Second Circuit opinion (Sotomayor, J., joined by Oakes and Wesley, JJ.), affirming in part, reversing in part and vacating in part Judge Pollack's order is published at 395 F.3d 25 (2d Cir. 2005) and reprinted at Pet. App. 1a-52a.

STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on January 11, 2005. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The pertinent provisions of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA"), amending the Securities Act of 1933, (15 U.S.C. § 77a *et seq.*), are codified at 15 U.S.C. § 77p, and the pertinent provisions amending the Securities Exchange Act of 1934, (15 U.S.C. § 78a *et seq.*), are codified at 15 U.S.C. § 78bb(f). These provisions are reproduced at Pet. App. 56a-69a. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (2004), are reproduced at Pet. App. 70a-71a.

In pertinent part, Section 28 of the Securities Exchange Act of 1934, as amended by SLUSA, provides:

> (1) *Class Action Limitations*. No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> > (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
> >
> > (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1) (Pet. App. 64a).

STATEMENT

A. *Introduction*

This case involves the interpretation of the Securities Litigation Uniform Standards Act of 1998. SLUSA mandates that class action litigation involving nationally-traded securities proceed only under the federal securities laws. Thus, SLUSA completely preempts

> covered class action[s] based upon the statutory or common law of any State or subdivision thereof

> . . . by any private party alleging: (A) a misrepresentation or omission of a material fact *in connection with the purchase or sale* of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1) (Pet. App. 64a) (emphasis added) *accord* 15 U.S.C. § 77p(b) (Pet. App. 56a).[1] SLUSA's preemptive effect applies whether the state law claims are brought in federal or state court.

SLUSA was passed in an effort to displace divergent state laws and, thereby, to create a uniform, national standard of liability for conduct involving nationally traded securities.

> Some critics of establishing a uniform standard of liability have attacked such legislation as being an affront on Federalism and contrary to the recent trend towards reinforcing state rights. Proponents of the legislation have argued that we live in an information age in which we have truly national, if not international, securities markets and that uniform standards are entirely consistent with Congress's preeminent power over the regulation of interstate and foreign commerce. The Committee, while sensitive to both these considerations, found the interest in promoting

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1. SLUSA provides that any covered class action meeting the criteria for preemption "shall be removable to the Federal district court for the district in which the action is pending." 15 U.S.C. §§ 77p(c), 78bb(f)(2) (Pet. App. 56a-57a, 63a).

> efficient national markets to be the more convincing and compelling consideration in this context.

S. Rep. No. 105-182 at 4 (1998), *available at* 1998 WL 226714, at *4 (footnote omitted); *see also Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107-08 (2d Cir. 2001) (SLUSA was "intended to promote uniformity in the securities markets" and prevent "strike suits"). Consistent with this goal, Congress sought to prevent what became known as a "federal flight" by class action plaintiffs seeking to avoid the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995,[2] by filing such claims in state courts. (Pet. App. 13a.)

The Second Circuit, in the decision below, erroneously created a non-statutory exception to SLUSA's complete preemption by holding that the judicially crafted purchaser-seller standing limitation for private securities fraud actions adopted by this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, should be read into the construction of SLUSA's "in connection with" requirement. (Pet. App. 52a.) Under the Second Circuit's interpretation of SLUSA, plaintiffs may maintain – under state law theories and in state courts – class action claims alleging that defendants made misstatements or omissions in connection with the purchase or sale of securities, provided that the putative class purports to exclude any person who actually traded in the subject securities during the putative class period.

In direct contrast, Judge Easterbrook, writing for the Seventh Circuit last week, held that the "in connection with

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2. Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 U.S.C. §§ 77z-1, 78u-4).

the purchase or sale" language in SLUSA is "as broad as § 10(b) itself" and is not affected by "limitations on private rights of action to enforce § 10(b)," such as the purchaser-seller requirement rule adopted by the Court in *Blue Chip Stamps*. *See Kircher v. Putnam Funds Trust*, 2005 U.S. App. LEXIS 5372, at *15 (7th Cir. Apr. 5, 2005). Indeed, Judge Easterbrook recognized that the very claims that the Second Circuit permitted to proceed as state law claims were precisely those that Congress intended to preempt:

> It would be more than a little strange if the Supreme Court's decision [in *Blue Chip Stamps*] to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all.

Id. at *13. Under the Seventh Circuit's interpretation of SLUSA, the identical class action that would not be preempted in the Second Circuit must be dismissed as preempted in the Seventh Circuit. *See id.* at *10-15.[3]

This Court should grant review to resolve this direct, acknowledged conflict.

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3. As Judge Easterbrook noted and as discussed more fully below, the view of the Seventh Circuit is also in conflict with the decisions of the Eighth and Eleventh Circuits. The Third Circuit, by contrast, appears to support the view of the Seventh Circuit. *See Kircher*, 2005 U.S. App. LEXIS 5372, at *10-11.

B. ***Proceedings Below***

In the wake of allegations by the New York Attorney General that Petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") had issued research reports with respect to a number of publicly traded securities that were allegedly biased and not "objective," more than 160 federal securities actions were commenced in no less than 20 federal courts. On April 26, 2002, Respondent Shadi Dabit, a former Merrill Lynch broker, brought a putative class action in the federal district court for the Western District of Oklahoma seeking to represent present and former brokers of Merrill Lynch. Respondent purported to assert claims under state law for breaches of fiduciary duty and the covenant of good faith and fair dealing based on the same allegations that formed the basis of the federal securities actions. Among other things, Respondent pled that various acts and practices, which he described as "hallmarks of stock manipulation," allegedly caused the putative class harm as a result of their "owning and holding" some forty-eight different, nationally traded stocks.

The Oklahoma district court dismissed Respondent's first complaint as preempted by SLUSA and, thereafter, Respondent filed a virtually identical amended complaint that simply eliminated all references to stock purchases; the complaint continued to seek damages "as a result of owning and holding" the same forty-eight stocks. Respondent's case was transferred by the Judicial Panel for Multidistrict Litigation to the late Honorable Milton Pollack, Senior United States District Judge for the Southern District of New York.

On April 10, 2003, Judge Pollack dismissed four complaints – including Respondent's amended complaint – as preempted by SLUSA. (Pet. App. 53a-55a.) Judge Pollack held that

Respondent's state law class action claims were preempted because the claims were "based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court." (Pet. App. 55a.) Respondent appealed to the United States Court of Appeals for the Second Circuit.

Following oral argument, on March 22, 2004, the Second Circuit requested the views of the United States Securities and Exchange Commission ("SEC") in connection with the resolution of Respondent's appeal. Among other things, the court inquired of the SEC:

a. Whether, in requiring that a preempted action allege wrongdoing "in connection with the purchase or sale" of covered securities under SLUSA, Congress intended the "in connection with" requirement to have the same meaning as the identical term used in the antifraud provision in Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78j(b)?

b. "Whether the purchaser-seller rule of standing . . . enunciated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), should be adopted for SLUSA?"

c. "Whether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5?"

On June 22, 2004, the SEC filed an Amicus Brief to address these and several other questions posed by the Second Circuit. The SEC answered the questions as follows:

1. Yes. The "in connection with" language in SLUSA has the same meaning it has under § 10(b) (Pet. App. 80a-83a);

2. No. Adoption of a purchaser-seller rule for SLUSA is neither consonant with the statutory language nor SLUSA's legislative purpose (Pet. App. 88a-94a); and

3. Yes. Where the statutory requirements are satisfied, SLUSA preempts class actions under state law that could not have been brought pursuant to § 10(b) and Rule 10b-5 (Pet. App. 87a, 95a-99a).

C. *The Decision Below*

On January 11, 2005, the Second Circuit issued its opinion, affirming in part, vacating in part and remanding in part Judge Pollack's decision dismissing Dabit's complaint with prejudice. (Pet. App. 43a-52a.) The Second Circuit disagreed with the SEC (Pet. App. 26a-36a), and contravened the plain meaning of the statute. Instead, the Second Circuit held that "the purchaser-seller rule affirmed in *Blue Chip* applies to the construction of 'in connection with' under SLUSA" (Pet. App. 52a), reasoning that the legislative history of SLUSA did not suggest that Congress intended to preempt claims not "capable of being brought under federal law" (Pet. App. 21a).

Noting that Congress was aware of the judicially-created purchaser-seller standing requirement in private rights of action seeking damages under § 10(b) when it borrowed the "in connection with" language of § 10(b) in SLUSA, the Second Circuit concluded that Congress was "aware of and approve[d] that construction." (Pet. App. 29a.) The court held that "holders" claims were not preempted because *Blue Chip Stamps* applies as a limit on private rights of action under Section 10(b) and because the class of plaintiffs addressed

by SLUSA seek damages in private rights of action. The court stated, "it is . . . natural to suppose that Congress meant to import the settled standing rule along with the 'in connection with' phrase as a substantive standard." (Pet. App. 28a.)

The Second Circuit also cited the congressional goal of "closing the 'federal flight loophole' by stemming the migration of claims from federal to state court." (Pet. App. 21a.) Once again disagreeing with the SEC (Pet. App. 29a-35a; *compare* Pet. App. 88a-99a), the court concluded that SLUSA was intended to apply only to claims that could have been brought in federal court under the PSLRA:

> If the "in connection with" phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA. If it were otherwise, actions might be preempted for meeting all of SLUSA's requirements, including the "in connection with" term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.

(Pet. App. 21a; *see also id.* 35a.)

Thus, the court below held that the purchaser-seller rule applies to the construction of "in connection with" under SLUSA. In so concluding, the Second Circuit disagreed with prior precedent from this Court and the SEC's view that the purchaser-seller requirement is not a construction of the "in

connection with the purchase or sale" requirement. (Pet. App. 26a-28a; *see* Pet. App. 80a-83a, 87a-94a.)

> [W]e find defendants' and the SEC's position concerning the applicability of *Blue Chip*'s purchaser-seller rule unpersuasive. Congress employed language with a settled judicial interpretation of which *Blue Chip* was a part and we see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish nonpurchaser and nonseller state class action claims.

(Pet. App. 27a.)

The court accordingly held that Respondent's state law claims for damages from "holding" securities are not preempted by SLUSA provided that he repleads so as to exclude from his putative class any person who purchased or sold securities during the putative class period. (Pet. App. 43a.)[4]

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4. The Second Circuit's opinion below was addressed to two separate cases, *Dabit v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 03-7499 and *IJG Investments v. Merrill Lynch & Co.*, Docket No. 03-7458, which had been set for argument together. (*See* Pet. App. 1a.) Review is sought only of the portion of the decision in *Dabit* below holding that Respondent may avoid preemption by repleading his complaint to exclude from his putative class persons who traded the subject securities during the putative class period.

REASONS FOR GRANTING THE PETITION

The decision below conflicts directly with a recent opinion of the Court of Appeals for the Seventh Circuit (Easterbrook, J.) on an important issue of federal statutory law that greatly impacts the nation's economy and capital markets. If allowed to stand, the decision below will undermine Congress's express purpose in enacting SLUSA: to provide a uniform national standard of liability for class actions seeking damages for misconduct alleged to affect nationally traded securities by eliminating "fragmentation of investor remedies" which "potentially impose[d] costs that outweigh[ed] the benefits" and thereby to promote the "efficient operation of those markets and the optimal allocation of available capital." S. Rep. No. 105-182, at 3-5 (1998), *available at* 1998 WL 266714, at *3-5 (interest in promoting efficient national markets was "compelling consideration").

A. There is a Direct and Deep Conflict Among the Circuits Concerning the Question Presented in this Case.

The Second Circuit's holding in *Dabit*, interpreting SLUSA's "in connection with the purchase or sale of a . . . security" requirement as limited by the purchaser-seller rule of *Blue Chip Stamps*, squarely conflicts with the Seventh Circuit's holding that SLUSA's "in connection with" requirement does not incorporate the purchaser-seller rule. *See Kircher*, 2005 U.S. App. LEXIS 5372, at *11-15. The conflict is wide and deep and will not benefit from further percolation. The Third Circuit, though not reaching the issue, has suggested that it disagrees with the decision below because it conflicts with the views of the SEC and with

opinions of this Court. *See Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 300-04 (3d Cir. 2005); *see* Pet. App. 72a-100a. The Eighth and Eleventh Circuits, under very different sets of facts, have simply concluded (without analysis) that the *Blue Chip Stamps* purchaser-seller rule is a judicial construction of the "in connection with" requirement, thereby aligning themselves with the Second Circuit. *See Green v. Ameritrade, Inc.*, 279 F.3d 590, 596-98 (8th Cir. 2002); *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342-43 (11th Cir.), *cert. denied*, 537 U.S. 950 (2002).

As a result of the split in the circuits, SLUSA will necessarily fail in its purpose to establish uniform standards for conduct affecting nationally traded securities. This problem is exacerbated because the Second Circuit, as well as the Ninth and Eleventh Circuits, have held that they do not have appellate jurisdiction to review SLUSA remand orders, thereby rendering this issue incapable of further meaningful review. *See Williams v. AFC Enters., Inc.*, 389 F.3d 1185 (11th Cir. 2004); *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116 (2d Cir. 2003); *Abada v. Charles Schwab & Co.*, 300 F.3d 1112 (9th Cir. 2002).

B. The Second Circuit's Interpretation of SLUSA is Wrong on a Crucial Issue of Federal Statutory Law and Its Holding Will Eviscerate the Purpose of the Statute.

1. The Second Circuit's Reasoning Is Contrary to the Plain Language of the Statute and Is Flawed.

As set forth by Judge Easterbrook in *Kircher*, 2005 U.S. App. LEXIS 5372, and by the SEC in its *amicus* brief, the Second Circuit's reasoning is contrary to the plain language of the statute and is flawed. There is no dispute that Congress's use of the "in connection with a purchase or sale" language used in SLUSA has the same meaning as it does in § 10(b) of the Exchange Act, particularly since SLUSA amended the Exchange Act. Even the Second Circuit acknowledges this. (Pet App. 17a.)

Where the Second Circuit went wrong, however, was in its conclusion that the "in connection with" language is limited by the purchaser-seller standing requirement established in *Blue Chip Stamps*. (Pet. App. 52a.) The *Blue Chip Stamps* standing requirement is *not* a judicial construction of the "in connection with" requirement of § 10(b) of the Exchange Act. Instead, it is a judicially crafted limitation on standing that would prevent certain private plaintiffs from bringing actions that otherwise meet the statutory elements of § 10(b) of the Exchange Act, including the "in connection with" prong. *See Blue Chip Stamps*, 421 U.S. at 737-40 (explaining that such a rule was needed, citing "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"). As Justice O'Connor has explained, "[t]he purchaser/seller

standing limitation in Rule 10b-5 damages actions . . . does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.'" *Holmes v. SIPC*, 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and concurring in the judgment); *see also Kircher*, 2005 U.S. App. LEXIS 5372, at *12-13 (citing *United States v. O'Hagan*, 521 U.S. 642, 664 (1997); *Holmes v. SIPC*, 503 U.S. 258, 284 (1992); *United States v. Naftalin*, 441 U.S. 768, 774 n.6 (1979)); *Ontario Pub. Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27, 34 (2d Cir. 2004) (the purchaser-seller limitation and "in connection with" are two distinct inquiries), *cert. denied*, 125 S. Ct. 919 (2005).

Where the language of a statute is plain, the courts should "enforce it according to its terms." *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989) (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)). Thus, as Judge Easterbrook explained in *Kircher*, "[t]o say that SLUSA uses the same language as § 10(b) and Rule 10b-5 is pretty much to resolve the point." *Kircher*, 2005 U.S. App. LEXIS 5372, at *11.

> Section 10(b) defines a federal crime, and it also permits the SEC to enforce the prohibition through administrative proceedings. Invocation of this anti-fraud rule does not depend on proof that the agency or United States purchased or sold securities; instead the "in connection with" language ensures that the fraud occurs in securities transactions rather than some other activity. *See SEC v. Zandford*, 535 U.S. 813, 821-22, 153 L. Ed. 2d 1 (2002); *Superintendent of Insurance*

v. Bankers Life & Casualty Co., 404 U.S. 6, 12, 30 L. Ed. 2d 128 (1971).

Kircher, 2005 U.S. App. LEXIS 5372, at *11-12. Indeed, this is the very reasoning employed by the SEC in responding to the Second Circuit's inquiry. (Pet. App. 80a-87a.)

Judge Easterbrook also explained: "*Blue Chip Stamps* came out as it did . . . because a private right of action to enforce these provisions is a judicial creation and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm." *Id.* at *12 ("The Justices observed that anyone can *say* that a failure to trade bore some relation to what the issuer did (or didn't) disclose."). *Blue Chip Stamps*' purchaser-seller requirement limits "private actions to harms arising out of actual trading, which narrows the affected class and simplifies proof, while leaving other securities offenses to public prosecutors." *Id.* Thus, by limiting their putative classes to persons who did not trade any securities, plaintiffs did not thereby take their claims outside of § 10(b) and Rule 10b-5's "in connection with" requirement; "instead they demonstrate only that the claims must be left to public enforcement." *Id.* at *13.

Because the purchaser-seller requirement of *Blue Chip Stamps* is not a construction of the "in connection with" requirement of the federal securities laws, but rather serves the entirely separate purpose of limiting judicially implied private rights of action under federal law, there is no basis to import that limit to SLUSA. To the contrary, as explained more fully below, to hold otherwise, as did the court below, would be to allow individuals a private right of action to bring, as class actions, securities claims under state law that are expressly *disallowed* under federal law.

2. The Second Circuit's Decision Will Undermine the Express Purpose of the Statute.

If allowed to stand, the Second Circuit's reasoning will undermine the very purpose of SLUSA. More than twenty years before the enactment of the PSLRA and SLUSA, this Court recognized that the nature of securities actions, as well as liberal discovery provisions of the Federal Rules of Civil Procedure, presented the real possibility of abuse in that such actions will have a settlement value out of proportion to their prospect of success at trial. *See Blue Chip Stamps*, 421 U.S. at 740. Twenty years later, Congress found that such abuses, especially in the class action context, were having a deleterious impact on the nation's economy and the capital markets. To cure this problem, Congress enacted the PSLRA which, among other things, heightened the pleading requirements for alleging claims under the federal securities laws. *See* H.R. Conf. Rep. No. 104-369, at 31-32, 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31, 740). It did not take long, however, before creative plaintiffs' securities lawyers sought to find ways around the PSLRA and began to bring actions in the state courts. To remedy this "federal flight" and to ensure that national, federal standards would be applied to nationally traded securities, Congress enacted the Securities Litigation Uniform Standards Act of 1998. *See Lander*, 251 F.3d at 107-08.

As its name suggests, SLUSA was intended to ensure that, in the class action context, the federal securities laws would dictate a uniform standard of liability for conduct involving nationally traded securities. Congress "found the interest in promoting efficient national markets to be the . . . compelling consideration in this context." S. Rep. No. 105-182, at 4 (1998), *available at* 1998 WL 266714, at *4. As long as there is a split in the circuits as to what "in connection with" means in the

context of SLUSA preemption, the congressional goal of uniform standards will be defeated. Furthermore, the likelihood of inconsistent standards being applied is greatly exacerbated because the majority of circuits to have considered the question hold that remand orders issued after removal under SLUSA are unreviewable by the circuits. *See Williams*, 389 F.3d 1185; *Spielman*, 332 F.3d 116; *Abada*, 300 F.3d 1112.

Since the enactment of SLUSA, the plaintiffs securities bar has responded again by trying to take advantage of what they perceive as a loophole in the congressional intent to subject such actions to one federal standard. Equating SLUSA's 'in connection with' language with being "'able to pursue a private right of action after *Blue Chip Stamps*,'" *Kircher*, 2005 U.S. App. LEXIS 5372, at *9, the plaintiffs' bar has brought a variety of class actions purporting to assert harms arising out of "holding" securities. While prior to SLUSA's passage such cases were all but non-existent, they have proliferated at an alarming rate.[5] And yet, non-trading

5. Published and electronically available opinions include: *Prof'l Mgmt. Assocs. v. KPMG LLP*, 335 F.3d 800 (8th Cir. 2003) *cert. denied*, 540 U.S. 1162 (2004); *Riley v. Merrill Lynch, Pierce, Fenner & Smith*, 292 F.3d 1334 (11th Cir. 2002); *Davis v. Kozlowski*, 2005 U.S. Dist. LEXIS 4481 (D.N.H. Mar. 17, 2005); *Atencio v. Smith Barney*, 2005 U.S. Dist. LEXIS 1526 (S.D.N.Y. Feb. 2, 2005); *Gordon v. Buntrock*, 2005 U.S. Dist. LEXIS 57 (N.D. Ill. Jan. 3, 2005); *In re Alger, Columbia, Janus, MFS, One Group, & Putnam Mut. Fund Litig.*, 320 F. Supp. 2d 352 (D. Md. 2004); *Grabow v. PricewaterhouseCoopers LLP*, 313 F. Supp. 2d 1152 (N.D. Okla. 2004); *Vogeler v. Columbia Acorn Trust*, 2004 U.S. Dist. LEXIS 9182 (S.D. Ill. Feb. 12, 2004); *Potter v. Janus Inv. Fund*, 2004 U.S. Dist. LEXIS 9181 (S.D. Ill. Feb. 9, 2004); *Meyer v. Putnam Int'l Voyager Fund*, 220 F.R.D. 127 (D. Mass. 2004); *Kircher v. Putnam Funds Trust*, 2004 U.S. Dist. LEXIS 10327 (S.D. Ill. Jan. 23, 2004); *Bradfisch v. Templeton Funds, Inc.*, 319 F. Supp. 2d 897 (S.D. Ill. (Cont'd)

"holder" claims under state law were precisely the "sort of maneuver[ing] that SLUSA is designed to prevent." *Kircher*, 2005 U.S. App. LEXIS 5372, at *15. SLUSA's "preemptive effect is not confined to knocking out state-law claims by investors who have *winning* federal claims, as plaintiffs suppose. It covers both good and bad securities claims – *especially* bad ones." *Id.* at *15; *see also* Pet. App. 77a-80a, 93a, 95a-99a ("Were the [purchaser-seller] rule to apply under SLUSA it would have the opposite effect [from its effect in *Blue Chip Stamps*], in that it would allow lawsuits with precisely these vexatious characteristics to go forward.").

The decision below now judicially approves the opening of the door to this improper loophole which can only now be shut through the resolution of the split amongst the Circuits.

(Cont'd)

2004); *Cape Ann Investors LLC v. Lepone*, 296 F. Supp. 2d 4 (D. Mass. 2003); *Gordon v. Variable Prods. Fund III*, 2003 U.S. Dist LEXIS 24738 (S.D. Fla. Dec. 4, 2003); *Ray v. Citigroup Global Mkts., Inc.*, 2003 U.S. Dist. LEXIS 20966 (N.D. Ill. Nov. 20, 2003); *Feitelberg v. Credit Suisse First Boston LLC*, 2003 U.S. Dist. LEXIS 19116 (N.D. Cal. Oct. 21, 2003); *Tittle v. Enron Corp.*, 284 F. Supp. 2d 511 (S.D. Tex. 2003); *Dacey v. Morgan Stanley Dean Witter & Co.*, 263 F. Supp. 2d 706 (S.D.N.Y. 2003); *Chinn v. Belfer*, 2002 U.S. Dist. LEXIS 20343 (D. Or. June 19, 2002); *Korsinsky v. Salomon Smith Barney*, 2002 U.S. Dist. LEXIS 259 (S.D.N.Y. Jan. 9, 2002); *Hardy v. Merrill Lynch, Pierce, Fenner & Smith*, 189 F. Supp. 2d 14 (S.D.N.Y. 2001); *Shaev v. Claflin*, 2001 U.S. Dist. LEXIS 6677 (N.D. Cal. May 16, 2001); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584 (W.D. Tex. 2001); *Gordon v. Buntrock*, 2000 U.S. Dist. LEXIS 5977 (N.D. Ill. Apr. 28, 2000).

As Judge Easterbrook aptly put it:

> It would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all. *Blue Chip Stamps* combined with SLUSA may mean that claims of the sort plaintiffs want to pursue must be litigated as derivative actions or committed to public prosecutors, but this is not a good reason to undercut the statutory language.

Kircher, 2005 U.S. App. LEXIS 5372, at *13. "[P]laintiffs' effort to define non-purchaser-non-seller classes is designed to evade PSLRA in order to litigate a securities class action in state court . . . . It is the very sort of maneuver that SLUSA is designed to prevent." *Id.* at *14-15.

C. This Case Presents a Unique and Necessary Opportunity to Resolve the Circuit Conflict and Restore the Intent of SLUSA.

This case presents an appropriate vehicle and opportunity for this Court to resolve the Circuit conflict and the dispute over the breadth of SLUSA's preemption. As discussed above, the differing standards now being employed by the Circuits undermine the express statutory purpose underlying SLUSA and open the floodgates to an entirely new type of private securities class action – holding claims, which this Court expressly disallowed under federal law – by creating the purchaser-seller requirement.

While the split amongst the Circuit goes unresolved, these types of "holding" claims will only proliferate. *See supra* note 5. This concern is paramount here where it is the Second Circuit that has judicially opened the floodgates to such actions. The Second Circuit has been described as the "Mother Court" of federal securities jurisprudence. *See Blue Chip Stamps*, 421 U.S. at 762 (Blackmun, J., dissenting). Because the securities at issue are traded nationally, plaintiffs can virtually select any forum in which to bring their claims. Thus, as long as there is at least one such forum like the Second Circuit that allows such state law claims to proceed, it will serve as a portal for any plaintiff anywhere in the country to bring such claims, further undermining the purpose of SLUSA.

This presents an intolerable situation to publicly-listed companies and their shareholders, not to mention the nation's financial community. *See* S. Rep. No. 105-182, at 4 (1998), *available at* 1998 WL 266714, at *4 (state class-action litigation impairs capital formation and diverts resources, impairing the efficiency of our capital markets). Recognizing the *in terrorem* and other deleterious effects of allowing such state law claims to proceed, the statutory framework of SLUSA provides that any such actions can be immediately removed to federal court (if necessary) and then immediately dismissed. Moreover, SLUSA applies to preempt a breadth of actions involving a wide variety of financial products, including common stock, mutual funds, annuities and other insurance products. *See, e.g.*, *Lander*, 251 F.3d 101; *Kircher*, 2005 U.S. App. LEXIS 5372. Indeed, the only way to accomplish the congressional goals behind SLUSA – to establish uniform, federal standards and prevent federal flight – was to enact a statute of complete preemption that operates to dismiss such preempted actions at the outset of the litigation.

To allow this case to proceed will defeat the purpose of the statute by forcing Merrill Lynch to embark on costly and distracting litigation, which Congress expressly sought to prevent in enacting the PSLRA and SLUSA. In enacting the PSLRA and SLUSA, Congress explicitly recognized that the threat of costly and burdensome discovery is one tactic by which "innocent parties are often forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. No. 104-369, at 32 (1995), *reprinted in* 1995 U.S.C.C.A.N. at 731. As the House Report noted, "[i]nvestors always are the ultimate losers when extortionate 'settlements' are extracted from issuers." *Id.* The harms here are even more amplified because the same core allegations asserted in this case would not be sufficient to support a federal claim for securities fraud. *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005). This is precisely the situation Congress sought to avoid in enacting SLUSA.

The question presented in this petition will not be further refined or resolved by allowing it to further percolate amongst the Circuit courts. The question presented is a discrete – yet extremely important – issue of law which has now been decided definitively – in opposite ways – in at least the Second and Seventh Circuits. Furthermore, as discussed above, the Second Circuit (as well as the Ninth and Eleventh Circuits) has held that it lacks appellate jurisdiction over SLUSA remand orders. Accordingly, there will be no further opportunities for the Second Circuit to refine its jurisprudence, or for that matter, to provide for a ripe Circuit split again for this Court to resolve.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be granted. Petitioner also respectfully suggests that the Court's consideration of this Petition may be enhanced by receiving the views of the Solicitor General.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DECIDED JANUARY 11, 2005

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

August Term 2003

(Argued: December 15, 2003 Decided: January 11, 2005)

Docket Nos. 03-7499, 03-7458

SHADI DABIT,
on behalf of himself and all others similarly situated,

Plaintiff-Appellant,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
a corporation,

Defendant-Appellee.

IJG INVESTMENTS and IRLYS GUY,
on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

MERRILL LYNCH & CO., INC.,

Defendant-Appellee.

Before: OAKES, SOTOMAYOR and WESLEY, *Circuit Judges*.

Appendix A

SOTOMAYOR, *Circuit Judge*:

These two separate appeals, consolidated for purposes of oral argument and opinion, present an issue of first impression in this Circuit: whether the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227, which preempts certain class actions based upon state law brought by private parties alleging a misrepresentation or omission "in connection with the purchase or sale" of certain nationally traded securities, SLUSA § 101(b), 112 Stat. at 3230 (codified at 15 U.S.C. § 78bb(f)), preempts claims that do not allege that putative class members purchased or sold particular securities in reliance upon the defendant's alleged misconduct. Plaintiffs brought the instant actions in the wake of an investigation by the New York Attorney General into conflicts of interest that arose within certain large investment firms. Both actions alleged that defendants-appellees Merrill Lynch & Co., Inc. and Merrill Lynch Pierce Fenner Smith, Inc. (collectively, "Merrill Lynch")[1] issued biased research and investment recommendations designed to garner investment banking business and sought relief under state law. Plaintiff-appellant Shadi Dabit ("Dabit") brought a putative class action against Merrill Lynch in the United States District Court for the Western District of Oklahoma on diversity grounds. Plaintiffs-appellants IJG Investments Limited Partnership ("IJG Investments") and Irlys Guy (collectively, "IJG")

1. Defendant-appellee Merrill Lynch & Co. is the parent company of defendant-appellee Merrill Lynch, Pierce, Fenner & Smith Inc. Because the corporate structure of these companies is not relevant on this appeal, we refer to defendants throughout this opinion simply as "Merrill Lynch."

brought a putative class action against Merrill Lynch in Minnesota state court. After removal of the IJG action to federal court and subsequent coordinated proceedings of both actions in the Southern District of New York, the district court dismissed the lawsuits under Federal Rule of Civil Procedure 12(b)(6) as preempted by SLUSA.

On appeal, plaintiffs contend that SLUSA does not preempt their actions because their complaints do not allege misrepresentations or omissions of material fact "in connection with the purchase or sale of . . . covered securit [ies]." Dabit argues that SLUSA's "in connection with" requirement is not satisfied because he seeks only (i) "holding" damages—damages incurred because Merrill Lynch fraudulently induced him to retain certain securities—and (ii) commissions that he would have earned from clients that he lost by recommending securities touted in Merrill Lynch's allegedly false research reports. IJG argues that preemption is inappropriate because it seeks merely "the cost of doing business"—specifically, flat fees and commissions—relating to IJG's payments for access to Merrill Lynch's proprietary research, a nexus asserted to be insufficiently "in connection with" the purchase or sale of securities to trigger preemption.

For reasons to be discussed, we hold that (i) the meaning of "in connection with" under SLUSA is coterminous with the meaning of the nearly identical language of § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Pub. L. No. 73-291, 48 Stat. 881, 891 (1934) (codified at 15 U.S.C. § 78j(b)), and its corresponding Rule 10b-5, 17 C.F.R. § 240.10b-5, and (ii) the purchaser-seller rule of

Appendix A

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), applies as a limit on SLUSA's "in connection with" requirement such that SLUSA does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members. Dabit's "holding" and IJG's commissions-based claims satisfy SLUSA's conditions requiring preemption because they contain implicit allegations of purchases made by plaintiffs and putative class members. Thus, we affirm the judgment below to the extent it found these claims preempted. We vacate, however, so much of the judgment as dismissed Dabit's lost-commission claim and dismissed the remaining claims with prejudice, and remand to the district court to dismiss these claims without prejudice so that plaintiffs may (if the pertinent facts warrant) bring new actions that do not include allegations of fraud "in connection with the purchase or sale of a . . . security."

BACKGROUND

We summarize below the allegations of Dabit's and IJG's complaints, and assume their truth, as we must upon review of a dismissal pursuant to Federal Rule of Civil Procedure 12(b)(6). *Ideal Steel Supply Corp. v. Anza*, 373 F.3d 251, 254 (2d Cir. 2004).

1. Dabit's Complaint and Amended Complaint

Dabit, a former broker of Merrill Lynch, initially sued on April 26, 2002, on behalf of himself and other current and former Merrill Lynch brokers who, from December 1, 1999, through December 31, 2000, (i) purchased and

refrained from selling Merrill Lynch-recommended securities because of Merrill Lynch's misleading research and recommendations, and (ii) lost clients as a result of purchases of recommended stocks on behalf of clients and Merrill Lynch's alleged misconduct. Dabit alleged breaches of fiduciary duty and of the covenants of good faith and fair dealing (presumably under Oklahoma law—the complaint does not tell us). Dabit filed his action in the United States District Court for the Western District of Oklahoma, alleging jurisdiction on diversity grounds. The complaint attached two exhibits: a list of stocks purchased by Dabit and recommended to Dabit's alleged lost customers during the class period based on Merrill Lynch's recommendation (the "ML stocks"); and a report prepared by the Office of the Attorney General of New York concerning Merrill Lynch's scheme to attract investment banking business by overrating certain stocks and causing the inflation of their prices. The complaint further alleged that Merrill Lynch's "manipulative efforts," which included illegal sales efforts described as "the hallmarks of stock manipulation," caused these stocks to trade at "artificially inflated" prices. On October 11, 2002, the district court dismissed Dabit's initial complaint as preempted by SLUSA, calling it a "hopeless melange of purchase-related and holding-related assertions." Nevertheless, the district court allowed Dabit to re-plead because it was "conceivable that claims based on wrongfully-induced holding could be pleaded."

In his amended complaint, filed on October 21, 2002, Dabit replaced the original complaint's numerous references to purchases of securities with references instead to the

owning or holding of securities. For example, Dabit's putative class was amended to include those brokers who

> owned and continued to own one or more of the [Merrill Lynch] recommended securities . . . or recommended such securities to their clients during the period of December 1, 1999 through December 31, 2000[,] . . . and who suffered damages as a result of owning and holding such [Merrill Lynch] Stocks during this time period, or who suffered damages as a consequence of the loss of clients due to [Merrill Lynch's] wrongful actions. . . .

Dabit also removed the original complaint's discussion of Merrill Lynch's alleged illegal sales efforts. The amended complaint, however, attached the same exhibits as the original complaint and contained several of the same allegations concerning Merrill Lynch's causing certain stocks to trade at "artificially inflated" prices through the use of deceptive devices alleged to be the "hallmarks of stock manipulation." As in the initial complaint, the breach of fiduciary duty and breach of covenants of good faith and fair dealing were the only claims asserted.

On October 23, 2002, the Judicial Panel for Multidistrict Litigation conditionally transferred the Dabit action to the Southern District of New York where more than 120 additional cases against Merrill Lynch arising from the New York Attorney General's investigation were being centralized. The Panel also transferred five other putative class actions alleging state law claims in connection with Merrill Lynch's

false research (including IJG's action) to the Southern District of New York for coordinated proceedings before Judge Pollack. Merrill Lynch moved to dismiss Dabit's complaint under Rule 12(b)(6) as preempted by SLUSA.

2. IJG's Complaint

On June 7, 2002, IJG filed its putative class action in Minnesota state court, asserting breach of contract and consumer fraud claims under Minnesota law for damages arising from its relationship as a retail brokerage customer of Merrill Lynch.[2] The crux of IJG's complaint is that Merrill Lynch provided biased investment advice in violation of its contract with IJG.

The contracts at issue arose out of retail cash management accounts opened by IJG Investments, an investment partnership, and Guy, an individual investor, with Merrill Lynch. Specifically, Guy maintained a cash management account with Merrill Lynch, and the partnership held the business counterpart of that account, a working capital management account. Merrill Lynch charged IJG an annual participation fee for subscription to these accounts, which IJG paid. IJG asserts that it and Merrill Lynch understood that the fees paid were in exchange for objective

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2. IJG alleged violations of the Minnesota Consumer Fraud Act, Minn. Stat. §§ 325F.68-.70, the Uniform Deceptive Trade Practices Act, Minn. Stat. § 325D.43-.48, and Minn. Stat. § 325F.71, which provides additional penalties for certain violations of those two statutes when perpetrated against senior citizens or handicapped persons, as well as common-law breaches of contract and the duty of good faith and fair dealing.

research promised by Merrill Lynch. Merrill Lynch also charged IJG commissions for engaging in securities trades in its brokerage account.

IJG's complaint, like Dabit's, alleged that Merrill Lynch issued false and misleading reports concerning publicly traded securities in order to garner investment banking business for Merrill Lynch. Despite the alleged understanding that IJG paid fees and commissions in exchange for objective research, the complaint asserted, Merrill Lynch "routinely used biased advice as a way to curry favor with various companies in order to sell investment banking services to those companies" and in return "earned lucrative investment banking fees."

IJG defined its putative class to include "[a]ll persons or entities who maintained retail brokerage accounts with Merrill Lynch, and who paid a commission or fees to Merrill Lynch." The complaint sought damages for injuries caused by the research reports' lack of objectivity. Under one cause of action, IJG alleged that Merrill Lynch's "conduct caused senior citizens to suffer a substantial loss of property set aside for retirement or for personal or family care and maintenance." Notwithstanding this broad description of potential damage claims regarding senior citizens, IJG's prayer for relief asserted that it sought only restitution of "funds wrongly withheld, charged or retained" by Merrill Lynch and "actual damages including, but not limited to, attorney fees, costs and expenses incurred in paying for valueless services." IJG maintains on this appeal that it seeks to recover only the amounts paid as (i) flat fees and (ii) commissions paid for purchases or sales of securities

falsely reviewed by Merrill Lynch, and thus not on any losses stemming from the diminished values of securities actually bought or sold.

On July 5, 2002, Merrill Lynch removed the IJG action to the United States District Court for the District of Minnesota on the grounds of diversity and SLUSA preemption. The Judicial Panel for Multidistrict Litigation conditionally transferred the case to the Southern District of New York on November 27, 2002 and consolidated it with several other actions before Judge Pollak (including Dabit's) related to Merrill Lynch's allegedly improper stock research. IJG moved to remand its case on January 9, 2003. In opposition, as discussed above, Merrill Lynch moved to dismiss the complaint and three of the other complaints, including Dabit's, pursuant to Rule 12(b)(6) for failure to state a claim as a result of SLUSA preemption.

3. The District Court's Dismissal of Both Actions

In an opinion and decision dated April 10, 2003, the district court denied IJG's motion to remand and dismissed, *inter alia*, both actions with prejudice as preempted under SLUSA. The district court found the state law claims to be "based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court," and held that the claims "fall squarely within SLUSA's ambit" because they allege "misrepresentations or omissions of material facts or [a] manipulative or deceptive device or contrivance in connection with the purchase or sale of a nationally traded security." These timely appeals followed.

Appendix A

DISCUSSION

We review *de novo* a ruling dismissing an action for failure to state a claim pursuant to Rule 12(b)(6). *Ortiz v. McBride*, 380 F.3d 649, 653 (2d Cir. 2004). All inferences must be drawn in favor of the nonmoving party. *Id.* We may affirm the dismissal only if " 'it appears beyond doubt that the plaintiff[s] can prove no set of facts in support of [their] claim[s] which would entitle [them] to relief.' " *McEachin v. McGuinnis*, 357 F.3d 197, 200 (2d Cir. 2004) (quoting *Flores v. S. Peru Copper Corp.*, 343 F.3d 140, 148 (2d Cir. 2003) (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957))). The district court's determination regarding SLUSA preemption is a conclusion of law and we therefore review it *de novo*. *See Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

1. SLUSA's Enactment and Scope

Congress enacted SLUSA in 1998 in response to the perceived failure of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104- 67, 109 Stat. 737 (codified in part at 15 U.S.C. § § 77z-1, 78u-4) to curb abuses of federal securities fraud litigation arising under the Securities Act of 1933 ("Securities Act"), Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a *et seq.*), and the Exchange Act. SLUSA § 2, 112 Stat. at 3227; *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1340 (11th Cir. 2002); *Lander*, 251 F.3d at 107-08. In construing the meaning of terms found in SLUSA, "we must view SLUSA in this larger statutory context." *Riley*, 292 F.3d at 1340.

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Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe. . . ." 15 U.S.C. § 78j(b). The SEC promulgated an accompanying rule, Rule 10b-5, which provides in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> *in connection with the purchase or sale of any security.*

17 C.F.R. § 240.10b-5 (emphasis added). Although Congress initially enacted § 10(b) "envision[ing] that the SEC would enforce the statutory prohibition through administrative and

injunctive actions," *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994), *abrogated on other grounds by* PSLRA § 104, 109 Stat. at 757 (codified at 15 U.S.C. § 78t), the federal courts have long recognized that the statute and its implementing rule give rise to a private cause of action for damages and injunctive relief. *See Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971); *see also Blue Chip*, 421 U.S. at 730 (noting that judicial implication of private right of action under § 10(b) and Rule 10b-5 provides "'a necessary supplement to Commission action.'" (citing *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964))).

Finding that plaintiffs were abusing this private cause of action by bringing meritless class actions—so-called "strike suits"—in the hope of coercing large settlements, Congress enacted the PSLRA in 1995 to provide more stringent and uniform standards for securities fraud class actions and other suits that alleged fraud in the securities markets. *See Lander*, 251 F.3d at 107 (citing H.R. Conf. Rep. No. 105-803 (1998)). Among other reforms, the PSLRA imposed heightened pleading standards for class actions alleging fraud in the sale of national securities and imposed a mandatory stay on discovery pending judicial determination of the legal sufficiency of the claims.[3] PSLRA § § 101(a),(b), 109 Stat. at 741, 746-47 (codified at 15 U.S.C. § § 77z-1(b), 78u-4(b)).

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3. In addition, because of perceived inefficiencies inherent in dual state and federal securities registration schemes, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (codified in part at 15 U.S.C. § 77r), primarily to preempt state "Blue Sky" laws that required issuers to register many securities with state authorities prior to marketing in the states. *See Lander*, 251 F.3d at 108.

Appendix A

As noted above, Congress enacted SLUSA in 1998 in response to the perceived failure of the PSLRA to achieve its goals. Congressional investigation revealed a "federal flight" loophole whereby many class action plaintiffs avoided the PSLRA's heightened requirements by bringing suit in state courts under state statutory or common law rather than in federal court. *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 123 (2d Cir. 2003); *Lander*, 251 F.3d at 108 ("[T]he decline in federal securities class action suits that occurred after the passage of [the] PSLRA was accompanied by a nearly identical increase in state court filings." (citing H.R. Conf. Rep. No. 105-803)); *see also* SLUSA § (2), 112 Stat. at 3227. In enacting SLUSA, Congress intended to close this loophole "by making federal court the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law." *Lander*, 251 F.3d at 108.

In pertinent part, SLUSA provides that:

> No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> (B) that the defendant used or employed any manipulative or deceptive device or

> contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1).[4] It further provides that such actions may be removed to federal court. 15 U.S.C. § 78bb(f)(2). Thus, four conditions must be satisfied to trigger SLUSA's removal and preemption provisions: (1) the underlying suit must be a "covered class action"[5]; (2) the action must be

4. SLUSA defines a "covered security" as "a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933, at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred. . . ." 15 U.S.C. § 78bb(1)(5)(E). Section 18(b) of the Securities Act of 1933 includes securities that are listed or authorized for listing on certain national securities exchanges. 15 U.S.C. § 77r(b)(1).

5. SLUSA defines a "covered class action" as:

> (i) any single lawsuit in which—
>
> > (I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or
> >
> > (II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to

(Cont'd)

based on state or local law; (3) the action must concern a "covered security"; and (4) the defendant must have misrepresented or omitted a material fact or employed a manipulative or deceptive device or contrivance "in connection with the purchase or sale of" that security. *Riley*, 292 F.3d at 1342.

This Court has noted that in enacting SLUSA, "Congress could not have spoken more clearly" about its intention "to completely preempt the field of certain types of securities class actions by essentially converting a state law claim into a federal claim and creating federal jurisdiction and venue for specified types of state securities fraud claims." *Spielman*, 332 F.3d at 123 (emphasis omitted). As we explained in *Spielman*, complete preemption "manifests a [c]ongressional policy determination that the 'state law claim in that area is of necessity so federal in character that it arises under federal

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(Cont'd)

> those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or
>
> (ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—
>
> (I) damages are sought on behalf of more than 50 persons; and
>
> (II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

15 U.S.C. § 78bb(f)(5)(B).

law.' " *Id.* at 123 n. 5 (quoting *Cicio v. Does*, 321 F.3d 83, 92 (2d Cir. 2003) (further internal quotation omitted)). It therefore "provides in practice an exception to the well-pleaded complaint rule," *id.*, such that when SLUSA's conditions have been satisfied, "the plaintiff has necessarily invoked federal question jurisdiction, even though he [or she] did not wish to," and the court must dismiss for failure to state a claim because SLUSA has preempted the state law basis for the claim, *id.* at 131-32 (Newman, J., concurring).

Under SLUSA, then, we must look beyond the face of the complaint to analyze the substance of the allegations made. "[P]erhaps mindful that SLUSA was intended to block artful plaintiffs, courts have gone beyond asking whether the removed complaint contains the talismanic phrase 'in connection with,' and have looked also to whether the allegations, if true, would satisfy the 'in connection with' requirement." *Id.* at 133 n.5; *see also Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 879 (8th Cir. 2002) (stating that where complete preemption applies, "plaintiff may not avoid federal question jurisdiction and the preemption of state law claims by artfully concealing the federal question in an otherwise well-pleaded complaint under state law").

Both IJG and Dabit allege that Merrill Lynch misrepresented the value of certain stocks, which are concededly covered securities under SLUSA, in order to attract investment banking business, all in violation of either Minnesota or Oklahoma law. Accordingly, plaintiffs do not dispute that their lawsuits are SLUSA "covered class actions" based upon state statutory or common law or, with the exception of one of IJG's claims, that they involve

misrepresentations and omissions that concern SLUSA-defined "covered securities." Rather, the principal question on this appeal is whether these purported misrepresentations and omissions were alleged to be "in connection with the purchase or sale" of the covered securities for purposes of SLUSA.

2. SLUSA's "In Connection With" Requirement

A. The Applicability of § 10(b) and Rule 10b-5 Jurisprudence

In determining the meaning of the broad phrase "in connection with the purchase or sale of a covered security" under SLUSA, we turn first to the language of the statute, for "[t]he starting point in every case involving construction of a statute is the language itself." *Blue Chip*, 421 U.S. at 756 (Powell, J., concurring). SLUSA, however, nowhere defines the phrase, and the Supreme Court has not yet interpreted this phrase in the context of SLUSA. The phrase has been extensively interpreted by the Supreme Court and the lower federal courts in the context of § 10(b) and Rule 10b-5, *see Blue Chip*, 421 U.S. at 731-32, and the parties and the SEC as *amicus curiae* urge us to refer to this body of law in construing SLUSA. We are persuaded that this is the correct approach.[6]

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6. After oral argument in these cases, the Court *sua sponte* invited the Securities and Exchange Commission (the "SEC" or the "Commission") to submit its views on the issues presented in this appeal. Accepting our invitation, the SEC submitted an *amicus curiae* brief. Where Congress has expressly or impliedly "delegat[ed]

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authority to [an] agency to elucidate [an ambiguous] . . . provision of [a] statute," the agency's interpretation will be given controlling weight so long as it is reasonable. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 843-44 (1984); *see also In re New Times Sec. Servs.*, 371 F.3d 68, 80 (2d Cir. 2004). The preemptive provisions of SLUSA, however, unlike the parallel provisions of § 10(b), do not create powers in the SEC or vest the SEC with any rulemaking, adjudicative or other enforcement or interpretive responsibility. Because *Chevron* deference is due only where "Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law" and where "the agency interpretation claiming deference was promulgated in the exercise of that authority," *United States v. Mead Corp.*, 533 U.S. 218, 226-27, 229 (2001), we do not apply it to the SEC's views concerning the meaning of SLUSA.

Where, as here, *Chevron* deference is inappropriate but "the agency has some special claim to expertise under the statute," the court defers to the agency's view to the lesser degree of extending "*Skidmore* deference." *Coke v. Long Island Care At Home, Ltd.*, 376 F.3d 118, 133 (2d Cir. 2004) (internal quotation and citation omitted). The level of deference owed to an agency's view under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), depends on "all those factors which give it power to persuade, if lacking power to control," *id.* at 140, including "the agency's expertise, the care it took in reaching its conclusions, the formality with which it promulgates its interpretations, the consistency of its views over time, and the ultimate persuasiveness of its arguments." *Cmty. Health Ctr. v. Wilson-Coker*, 311 F.3d 132, 138 (2d Cir. 2002) (citing *Mead*, 533 U.S. at 228, 234-35). Because, for reasons explained *infra*, we would independently reach the same conclusion as the SEC on the applicability of § 10(b) jurisprudence to the meaning of SLUSA's "in connection with" requirement, we need not engage in exhaustive analysis of these factors. *See id.* at 137-38 (declining to specify "the exact molecular weight of deference" owed to agency's position where not outcome-determinative).

Appendix A

All of the federal courts of appeals that have considered the issue have relied upon judicial interpretation of "in connection with" under § 10(b) and Rule 10b-5 in construing SLUSA. *See Riley*, 292 F.3d at 1342 (listing circuit court and district court cases); *see also Falkowski v. Imation Corp.*, 309 F.3d 1123, 1129 (9th Cir. 2002); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 597-98 (8th Cir. 2002).[7] In concluding that § 10(b) and Rule 10b-5 jurisprudence concerning the "in connection with" language applies to SLUSA, the Eleventh Circuit reasoned that "where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *Riley*, 292 F.3d at 1342 (internal quotation and alteration marks omitted). Further, as observed in *Riley* and by the Ninth Circuit in *Falkowski*, the application of § 10(b) jurisprudence is particularly appropriate because SLUSA is legislation intended to shore up the PSLRA, which in turn related to abuse of that provision. *Falkowski*, 309 F.3d at 1129 ("SLUSA should . . . be viewed as part of the remedial package of federal securities laws and should be construed accordingly."); *accord Riley*, 292 F.3d at 1342. For this reason, the Eleventh Circuit in *Riley* noted:

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7. *See also, e.g., Winne v. Equitable Life Assurance Soc. of the United States*, 315 F. Supp. 2d 404, 411-12 (S.D.N.Y. 2003); *Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377, 382 (E.D.N.Y. 2002); *Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, No. 01 Civ. 3013, 2001 WL 1182927, at *2-3 (S.D.N.Y. Oct. 9, 2001). *But see Shaw v. Charles Schwab & Co.*, 128 F. Supp. 2d 1270, 1273-74 (C.D. Cal. 2001) (declining to apply Supreme Court's flexible reading of "in connection with" requirement in § 10(b) in interpreting SLUSA because the statutes have different purposes).

> In enacting SLUSA, . . . Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention. In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the purchase or sale of a covered security" to have the same meaning in SLUSA that it has in § 10b-5.

292 F.3d at 1342-43.

We agree in full with this reasoning. "When . . . judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also Lorillard v. Pons*, 434 U.S. 575, 581 (1978) ("[W]here . . . Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute."); *Strom v. Goldman, Sachs & Co.*, 202 F.3d 138, 147 (2d Cir. 1999) ("Congress is presumed . . . to be aware of prior judicial interpretations of similar statutory

provisions."). Nothing in SLUSA's text or legislative history evinces a congressional intent to overcome this presumption. On the contrary, the application of this jurisprudence to the language as repeated in SLUSA comports with Congress's stated goal in enacting SLUSA of closing the "federal flight loophole" by stemming the migration of claims from federal to state court. *See* SLUSA § 2, 112 Stat. at 3227 (finding that "a number of securities class action lawsuits have shifted from Federal to State courts" and reciting that SLUSA aims to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]"); *accord Lander*, 251 F.3d at 107-08. If the "in connection with" phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA. If it were otherwise, actions might be preempted for meeting all of SLUSA's requirements, including the "in connection with" term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.[8]

8. Judge Newman, concurring separately in *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116 (2d Cir. 2003), observed that the phrase operates somewhat differently in SLUSA than in the context of actions brought under § 10(b) and Rule 10b-5. Under § 10(b) and Rule 10b-5, a plaintiff must prove that the fraud was "*actually* 'in connection with' the purchase or sale of a security, whereas under SLUSA, a defendant is required to show only that the *plaintiff has alleged* fraud 'in connection with' the purchase or sale of a security." 332 F.3d at 133 n.5 (Newman, J., concurring). Further,

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B. The Meaning of "In Connection With" a Purchase or Sale of Securities Under § 10(b) and Rule 10b-5

Long ago the Supreme Court instructed that the "in connection with" language in § 10(b) and Rule 10b-5 "must be read flexibly, not technically and restrictively" so that "novel" and "atypical" as well as "garden type variety" frauds do not escape its prohibitive scope. *Superintendent of Ins.*, 404 U.S. at 11 n.7 (1971); *see also SEC v. Zandford*, 535 U.S. 813, 819 (2002) (holding that § 10(b) should be "construed not technically and restrictively, but flexibly to effectuate its remedial purposes" (internal quotation and citation omitted)); *Steiner v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores Inc. Stock Litig.)*, 991 F.2d 953, 964 (2d Cir. 1993). Our cases have accordingly given an "expansive[ ]" construction to the "in connection with" requirement. *United States v. Russo*, 74 F.3d 1383, 1392 (2d Cir. 1996).

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Judge Newman noted that there are at least three procedural differences: First, the roles of the parties are reversed because the defendant invoking SLUSA preemption argues that the "in connection with" condition is satisfied while the plaintiff argues that it is not. Second, under SLUSA the district court must definitively resolve that question at the beginning of the case as part of its jurisdictional inquiry. Third, because the result of SLUSA preemption may be remand to state court, unreviewable under 28 U.S.C. § 1447(d), the availability of appellate review depends on the result of the "in connection with" inquiry. *Id.* at 133. None of these procedural differences compels a different interpretation of the substantive reach of the phrase "in connection with" under SLUSA.

The reach of the "in connection with" phrase, while broad, is of course not unlimited. "[T]he incidental involvement of securities d[oes] not implicate the anti-fraud provisions of the federal securities laws." *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986) (citing *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984)). The fraud must be "integral to the purchase and sale of the securities in question." *Id.* at 459; *see also Falkowski*, 309 F.3d at 1131 (holding that the fraud and stock sale must be "more than some tangential relation"). *Zandford*, the Supreme Court's most recent elaboration of the "in connection with" requirement, cautions that the phrase must not "be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b)." 535 U.S. at 820. In that case the Court held that a deceptive practice may be "in connection with" a securities transaction if it "coincide[s]" with the transaction, even where the fraud does not relate to the value of any particular investment vehicle. *Id.* Thus, while the Court held that a broker's fraudulent scheme of selling his clients' securities for his own benefit satisfied the "in connection with" requirement even though the fraud did not relate to the investment value of a security, the Court also noted in dicta that fraud unattached to any particular purchase or sale—such as outright embezzlement from the client's account—would not. *Id.* at 820, 825 n.4.

The question of whether a given fraud arises "in connection with the purchase or sale" of a security so as to give rise to a private action for damages is subject to an important procedural limitation as well. While the SEC or the United States may bring an enforcement action under the

Rule so long as "*someone* buy[s] or sell[s] the security during the period of allegedly fraudulent conduct," 8 Louis Loss & Joel Seligman, *Securities Regulation* 3721 (3d ed. 2004), private litigants may only bring an action under Rule 10b-5 when they are themselves purchasers or sellers of the securities in question. First announced in Judge Augustus Hand's seminal decision in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463-64 (2d Cir. 1952), this rule of standing gained wide acceptance throughout the lower federal courts; the Supreme Court ultimately ratified it in *Blue Chip*, 421 U.S. at 754-55.

In *Blue Chip*, a putative class of offerees of shares in a newly reorganized company sued under § 10(b) and Rule 10b-5 on the basis that the prospectus distributed in association with the offering was overly pessimistic. *See id.* at 726. The complaint alleged that the defendants had issued an intentionally and misleadingly sour prospectus to discourage purchases by the alleged class of offerees so that the rejected shares could then be sold at a premium to the public. *Id.* at 726- 27. After noting Congress's failure to adopt proposed amendments that would have made § 10(b) applicable to "attempts" to purchase or sell securities, the Court noted that "the longstanding acceptance [of the standing rule] by the courts" and Congress's "failure to reject *Birnbaum* 's reasonable interpretation of the wording of § 10(b)" provided persuasive justification to affirm the *Birnbaum* rule and to restrict the 10b-5 remedy to actual purchasers and sellers of securities. *Id.* at 733. Because private securities fraud actions were a creature of judicial implication and "[n]either Congress . . . [n]or the Securities and Exchange Commission . . . foreordained the present state

of the law with respect to Rule 10b-5," the Court found it proper to take policy considerations into account in determining the propriety of the standing rule. *Id.* at 737. Among the policy justifications for the rule was the concern that without it, "the door w[ould] be open to recovery of substantial damages on the part of one who offers only his own testimony" to prove that the defendant's fraud caused him, as the case might be, to fail to purchase or to fail to sell the security in question. *Id.* at 746. In contrast, imposition of the purchaser-seller rule would restrict recovery to those who could prove the "objectively demonstrable fact" of actual purchase or sale and would prevent vexatious lawsuits supported only by plaintiffs' self-serving testimony. *Id.* at 747. Such lawsuits were *ipso facto* likely to survive summary judgment and therefore to exact an "*in terrorem* . . . settlement" out of proportion to their likely merit. *Id.* at 741. The Court acknowledged that the standing rule was "an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5." *Id.* at 738, 95 S.Ct. 1917; *see also id.* at 743 ("The *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesirable."). But the Court noted that "this disadvantage is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." *Id.* at 738 n.9.

This Court and others have applied the *Blue Chip* purchaser-seller rule of standing to bar claims alleging fraudulently induced retention or delayed sales of securities. *See, e.g., Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977) (rejecting 10b-5 "holding" claims where plaintiffs fraudulently induced not to sell their securities),

disapproved on other grounds, *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979); *see also Gurley v. Documation Inc.*, 674 F.2d 253, 256-57 (4th Cir. 1982) (recognizing that literal application of *Blue Chip* does not foreclose a claim that the fraud caused a plaintiff to sell later than he otherwise would, but concluding that "the policies underlying the *Blue Chip* decision persuade[ ] us that one who claims that he was fraudulently induced to delay a sale of securities must, like a nonseller, be denied standing under § 10(b)"), *abrogated in part on other grounds by Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361 (1991); *O'Brien v. Cont'l Illinois Nat. Bank & Trust Co. of Chicago*, 593 F.2d 54, 58 (7th Cir. 1979).

C. Application of the *Blue Chip* Rule to SLUSA

Although, as noted above, the parties and the SEC are in general agreement that the meaning of SLUSA's "in connection with" requirement is the same as under § 10(b) and Rule 10b-5, the parties dispute the applicability of the purchaser-seller rule of standing as a substantive limit on the preemptive reach of that phrase as used in SLUSA. Merrill Lynch contends that the standing rule is irrelevant to whether a claim is preempted by SLUSA. The SEC joins in Merrill Lynch's position. Alternatively, Merrill Lynch argues that even supposing that the rule applies, SLUSA's "in connection with" requirement has been satisfied in both of the instant cases because plaintiffs' claims include allegations of actual purchases. In opposition, plaintiffs claim that *Blue Chip's* purchaser-seller rule applies to "in connection with" under SLUSA and that because they do not seek damages based upon any actual purchases or sales of securities, preemption is inappropriate here.

Appendix A

As discussed below, we find defendants' and the SEC's position concerning the applicability of *Blue Chip's* purchaser-seller rule unpersuasive. Congress employed language with a settled judicial interpretation of which *Blue Chip* was a part and we see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish nonpurchaser and nonseller state class action claims.[9] We do not, however, fully agree with plaintiffs' contentions that their actions cannot be read as alleging a purchase or sale of securities in connection with the alleged fraud.

Merrill Lynch and the SEC argue first that because the *Blue Chip* rule is a judicially-crafted rule of standing for a private litigant to maintain an action under § 10(b) and Rule 10b-5, and not an aspect of the substantive fraud prohibition itself, the rule should not be regarded as a limit on the meaning of the "in connection with" phrase and therefore on SLUSA's preemptive scope. The limitation on standing to bring private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities. *Ontario Pub. Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27, 34 (2d Cir. 2004) (observing that "the issue of standing" should not be conflated "with the question of whether the 'in connection with' requirement ha[s] been met"); *see also Blue Chip*, 421

9. Here again, as discussed *supra* note 6, we give the SEC's opinion as much deference as "the ultimate persuasiveness of its argument [ ]" demands, *Cmty. Health Ctr.*, 311 F.3d at 138, but do not defer to its view under *Chevron*.

U.S. at 751 n.14 (noting that even where a private party does not have standing to bring an action under Rule 10b-5, the SEC may bring an enforcement action that satisfies the "in connection with" requirement); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) ("[R]estrictions on who may invoke the power of the federal judiciary to enforce the securities laws by collecting damages do not bear on the determination of whether a violation of the securities laws has been committed."). That observation, however, has little persuasive force in this context, because SLUSA deals with precisely the category of actions subject to the purchaser-seller rule. Once it is agreed that Congress deliberately borrowed SLUSA's "in connection with" language from § 10(b), the fact that the standing rule is analytically distinct from the underlying prohibition on fraud does not compel the conclusion that SLUSA preempts more than the purchaser/seller category of private damages claims over which the "in connection with" source language operates. Because *only* purchasers and sellers have a federal private damages remedy, it is far more natural to suppose that Congress meant to import the settled standing rule along with the "in connection with" phrase as a substantive standard. Nor are we moved by the observation that the standing rule is merely a judge-made gloss on the statute and the Rule, because private Rule 10b-5 damages actions are themselves a creature of judicial implication. *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 593 (1995) ("[W]e have made no pretense that it was Congress' design to provide the [private 10b-5] remedy afforded." (internal quotation omitted)); *SEC v. Materia*, 745 F.2d 197, 202 (2d Cir. 1984) ("The private right of action under that section is a judicial, rather than a legislative creation.").

Second, the SEC also argues that the policy considerations underlying SLUSA militate against application of the purchaser-seller rule. Observing that SLUSA aimed to shore up the PSLRA's remedial goal of curbing meritless strike suits, the SEC contends that it would be anomalous for Congress to have meant to carry over the purchaser-seller rule as a limiting construction of the "in connection with" language, because the effect would be to *allow* the very category of claims that the Supreme Court identified in *Blue Chip* as posing a particularly high risk of vexatious litigation. This argument has some force as a matter of policy. *See* Amanda M. Rose, *Life after SLUSA: What Is the Fate of Holding Claims?*, 69 Def. Couns. J. 455, 462 (2002) ("[T]o some degree the persistence of holding claims may undermine the goals of the [PSLRA]."). The question in interpreting ambiguous statutory language, however, is not what Congress might sensibly want to do, but what Congress did. *Cf. American Airlines, Inc. v. Wolens*, 513 U.S. 219, 238 (1995) (O'Connor, J., concurring in the judgment in part and dissenting in part) (arguing that while the majority "arrive[d] at what might be a reasonable policy judgment as to when state law actions . . . should be pre-empted if we were free to legislate it," the conclusion was not consistent with the relevant statute as previously interpreted). As noted, Congress defined SLUSA's preemptive scope by borrowing language with a settled judicial interpretation in the context of private damages actions, and such borrowing implicates the strong presumption that Congress is aware of and approves that construction. Under that construction, the Supreme Court held that the judicially-adopted bar on federal non-purchaser and non-seller claims was counterbalanced by the existence of remedies under state law. *Blue Chip*, 421 U.S. at 738 n.9;

see also Small v. Fritz Cos., Inc., 65 P.3d 1255, 1261 (2003) ("[T]he high court's decision in *Blue Chip Stamps*, while recognizing policy considerations [weighing against holding claims], did not view those considerations as justification for a total denial of relief to defrauded holders; it reasoned only that the *federal* courts could deny a forum to wronged stockholders who are not sellers or buyers without unjust consequences because these stockholders retained a remedy in *state* courts."). SLUSA's wholesale importation of the language that gave rise to this balancing judgment must therefore be presumed to represent a ratification of that judgment. *Cf. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982) (explaining that Congress's "comprehensive reexamination and significant amendment" of the Commodities Exchange Act coupled with its failure to abrogate a provision of the Act under which courts had implied a cause of action, "is itself evidence that Congress affirmatively intended to preserve" that implied right of action); *Calif. Public Employees' Ret. Sys. v. WorldCom, Inc.*, 368 F.3d 86, 105 & n. 17 (2d Cir. 2004) (noting, in analyzing conflict between statutes including one amended by SLUSA, the "presumption that a prior legal rule should be retained if no one in legislative deliberations even mentioned the rule or discussed any changes in the rule" and concluding that "in light of its complete silence in 1998 with respect to [the conflict there at issue], Congress did not alter [the] preexisting rule when it enacted SLUSA." (internal quotation omitted)).

"[I]n deciding if federal law pre-empts state law . . . we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless

that was the clear and manifest purpose of Congress." *City of Milwaukee v. Illinois*, 451 U.S. 304, 316 (1981) (internal quotations omitted). Thus we will not regard a federal statute as completely preemptive of state law "absent some express statement or other clear manifestation from Congress." *Marcus v. AT&T Corp.*, 138 F.3d 46, 54 (2d Cir. 1998) (citing *Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 65-68 (1987)); *see also Spielman*, 332 F.3d at 123 n.5 ("[T]he complete preemption doctrine must be applied sparingly and with great restraint."). There is no clear support in the legislative history for the conclusion that Congress intended SLUSA to preempt claims that do not satisfy the *Blue Chip* rule.

The legislative history includes some language that generally indicates a broad preemptive intent,[10] but contains no specific mention of holding claims or other non-purchaser/non-seller claims. *See* Joshua D. Ratner, *Stockholders'*

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10. The conference report states that the purpose of SLUSA's preemptive provisions "is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court," and further states that "consistent with the determination that Congress made in the [NSMIA] . . . , [SLUSA] establishes uniform national rules for securities class action litigation involving our national capital markets." H.R. Conf. Rep. No. 105-803, at 13, 1998 WL 703964 (footnote omitted). The joint statement of the House and Senate managers of the conference committee declares broadly that "[u]nder the legislation, class actions relating to a 'covered security' . . . alleging fraud or manipulation must be maintained pursuant to the provisions of Federal securities law, in Federal court (subject to certain exceptions)." 144 Cong. Rec. H11,020 (daily ed. Oct. 15, 1998), 1998 WL 720293.

Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998, 68 U. Chi. L. Rev. 1035, 1059 (2001) (reviewing legislative history and suggesting that Congress may have been unaware of the existence of state law holding claims when it enacted SLUSA). In fact, to the extent the legislative history casts any light on the question, it suggests that Congress intended to preempt only those state claims that had migrated from federal court in response to the PSLRA. The statute itself explicitly states that it is intended to "prevent certain State private securities class action lawsuits alleging fraud from being *used to frustrate the objectives of the* [*PSLRA*]." SLUSA § 2(5), 112 Stat. at 3227 (emphasis added). The conference report reiterates that the purpose of SLUSA's removal and preemption provisions "is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, *rather than in Federal*, court," H.R. Conf. Rep. No. 105-803, at 13, 1998 WL 703964 (emphasis added), suggesting that Congress understood that it was only preempting claims that could have been brought in federal court to begin with. *See also id.* at 15 (noting that "solution" to the problem of disparate state liability regimes was to "make Federal court *the exclusive venue* for most securities fraud class action litigation involving nationally traded securities") (emphasis added).

The bill's primary proponents also indicated their understanding that SLUSA was aimed at preventing circumvention of PSLRA and that it therefore targeted only those claims that were meant to be brought in federal court subject to the PSLRA's restrictions. Senator Christopher J. Dodd, one of the bill's two principal Senate sponsors, stated

that SLUSA "if enacted, will allow Congress to address this State litigation problem . . . . in a very targeted and narrow way, essentially preempting only those class actions that have recently migrated to State court, while leaving traditional State court actions and procedures solidly in place." 143 Cong. Rec. S10,477 (daily ed. Oct. 7, 1997) (statement of Sen. Dodd), 1997 WL 614735.[11] Nonpurchaser/nonseller fraud class action claims were not among the "traditional State court actions" Senator Dodd offered as examples of non-preempted claims, but he reiterated that "[t]his legislation has been carefully crafted only to affect those types of class actions that *are appropriately heard on the Federal level.*" *Id.* (emphasis added). In addition, Representative Thomas J. Bliley, one of the House managers of the legislation, introduced the managers' joint explanatory statement accompanying the conference report by commenting, among other things, that "[i]f there is intentional fraud, there is nothing in this legislation or in the [PSLRA] to prevent those cases from proceeding." 144 Cong. Rec. H11,020 (daily ed. Oct. 15, 1998) (statement of Rep. Bliley), 1998 WL 720293. Rep. Bliley's statement suggests that he did not understand SLUSA to require removal of non-purchaser/non-seller class-action claims, because on that

11. Even some of the broad language of preemptive intent mentioned above lends itself to this construction: it would be odd to intend to "make Federal court the exclusive venue" for securities fraud claims that cannot be brought in federal court. H.R. Conf. Rep. 105-803 at 15. *Cf. Lander*, 251 F.3d at 110-11 (considering plaintiffs' claims that SLUSA did not intend to preempt class actions concerning variable annuities because "insurance litigation has traditionally occurred in state courts," and rejecting that argument because plaintiffs failed to demonstrate that such litigation "*always* occurred in state court" (emphasis added)).

view SLUSA would extinguish those claims for failure to satisfy the *Blue Chip* standing rule.

We have already found, in *Spielman*, that SLUSA applies only to "those state claims that fall within its clear preemptive scope, thereby confining federal question jurisdiction under this statutory regime to a subset of securities fraud cases," namely those that represent plaintiffs' flight from the burdens imposed by the PSLRA. *Spielman*, 332 F.3d at 124. Reviewing the legislative history, we discern no similarly clear intent on the part of Congress to go beyond closing this "federal flight" loophole.

We are similarly unmoved by the other arguments pressed by the SEC and Merrill Lynch. The SEC argues that it may be difficult to determine at the complaint stage whether putative classes contain actual purchasers or sellers, and that this problem is obviated by its interpretation of the statute. A finding that SLUSA is broadly preemptive of any class action implicating securities fraud is admittedly easier to administer than an interpretation that requires courts to scrutinize the pleadings with care. We are, however, "constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history," *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 566 (1979), and cannot permit our interpretation to be swayed by the concern that Congress has left the courts a difficult task. *Cf. Brown v. R.J. Reynolds Tobacco Co.*, 52 F.3d 524, 530 (5th Cir. 1995) ("Although we recognize the difficulties of applying [a legal test mandated by the statute in issue], . . . we are constrained by the language of the statute."). SLUSA is explicit that it is not completely preemptive of state

securities law, *see Spielman*, 332 F.3d at 123, and we cannot avoid the line-drawing issues that result.

Both Merrill Lynch and the SEC also argue that other elements necessary for maintenance of a successful action for damages under Rule 10b-5—such as scienter, reliance, loss causation and compliance with the statute of limitations—should not limit the court's construction of "in connection with" under SLUSA, and that it is therefore improper to apply the standing rule applicable to such claims as a limit on SLUSA preemption. This case does not present us with an opportunity to consider the applicability of those other Rule 10b-5 requirements to SLUSA, but supposing *arguendo* that they do not apply, we reject the asserted analogy. SLUSA, as we have repeatedly noted, was intended to bolster the PSLRA, which in turn was intended to toughen the requirements for maintenance of a successful action under Rule 10b-5. We need not and do not reach the question, but see no contradiction in concluding that Congress could have intended to preempt state law securities fraud actions that if brought under federal law would fail for proof of loss causation or lack of timely filing, but did not intend to preempt a category of actions that, because of the nature of the injury alleged, could never have constituted a potential federal action.

In sum, we hold that in enacting SLUSA Congress sought only to ensure that class actions brought by plaintiffs who satisfy the *Blue Chip* purchaser-seller rule are subject to the federal securities laws. We note that this holding aligns us with every circuit court that has considered the question thus

far. *See Riley*, 292 F.3d at 1343-45 (11th Cir.) (holding that under *Blue Chip*, SLUSA does not apply to claims dealing solely with the retention of securities rather than with their purchase or sale); *Falkowski*, 309 F.3d at 1130-31 (9th Cir.) (concluding, in determining whether claim is preempted by SLUSA, that *Blue Chip* purchaser-seller rule is satisfied); *Green*, 279 F.3d at 598 (8th Cir.) (interpreting *Blue Chip* to mean that "nonsellers and nonpurchasers of securities are not covered by SLUSA's preemption provision").[12] Given our conclusion that to be preempted, an action must allege a purchase or sale of covered securities made by the plaintiff or members of the alleged class, we analyze each of the plaintiffs' claims to determine whether the actions before us satisfy SLUSA's conditions for preemption.

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12. Merrill Lynch urges us to read *Professional Management Associates, Inc. Employees' Profit Sharing Plan v. KPMG LLP*, 335 F.3d 800 (8th Cir. 2003), as rejecting the view that the *Blue Chip* purchaser-seller requirement applies to SLUSA. The case does not go so far. The plaintiffs in *Professional Management* alleged that they "*bought* and retained their . . . shares" in reliance on the relevant misrepresentation. *Id.* at 802 (emphasis added). The court held that in light of their allegation of a purchase in reliance on the fraud, the plaintiffs could not "avoid preemption by . . . claiming [only] damages suffered as a result of holding its stock." *Id.* at 803. This ruling flows naturally from SLUSA, which bars claims "alleging" fraud in connection with purchase or sale, and is consistent with the Eighth Circuit's earlier holding in *Green* that the purchaser-seller rule applies. *Green*, 279 F.3d at 598.

Appendix A

3. The parties' claims

A. Dabit

Dabit asserts claims for two types of damages: (i) "holding" damages related to Merrill Lynch's fraudulent inducement of Dabit to retain certain securities and (ii) commissions that Dabit would have earned from clients that he lost as a result of Merrill Lynch's alleged fraud. Despite our application of the *Blue Chip* purchaser-seller rule, we conclude that Dabit's "holding" class as defined includes purchasers and thus that the putative class action includes allegations triggering SLUSA preemption.

A claim that a plaintiff purchased stock independent of any misrepresentation but was induced to retain it by a material misrepresentation or omission does not satisfy the *Blue Chip* standing requirement integral to the "in connection with" requirement of Rule 10b-5. *See Abrahamson*, 568 F.2d at 868. Other circuits have already concluded, at least in dicta, that SLUSA does not generally preempt such holding claims. *See Riley*, 292 F.3d at 1345 (noting that "under *Blue Chip*, SLUSA does *not* apply to claims dealing *solely* with the retention of securities, rather than with purchase or sale," but concluding that the plaintiff had failed to allege such a claim); *Green*, 279 F.3d at 599 (suggesting that a plaintiff could avoid SLUSA preemption "so long as his state-law claim does not require him to prove there was a sale or purchase of a covered security in reliance on the misrepresentation"); *cf. Falkowski*, 309 F.3d at 1131

(approving analysis in *Riley* and *Green*).[13] Our determination that the *Blue Chip* rule operates as a limit on the preemptive scope of SLUSA similarly commits us to the view that such holding claims are not preempted.[14]

When a plaintiff alleges that he purchased *and* retained stocks in reliance on a misrepresentation or omission of the defendant, however, the claim satisfies the *Blue Chip* rule and plainly falls within SLUSA's prohibition on state law claims "alleging . . . a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). In *Riley*, the Eleventh Circuit held that "when a claim that sweeps within

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13. *See also, e.g., Cape Ann Investors LLC v. Lepone*, 296 F. Supp. 2d 4, 11 (D. Mass. 2003); *Dacey v. Morgan Stanley Dean Witter & Co.*, 263 F. Supp. 2d 706, 711-12 (S.D.N.Y. 2003); *Shen v. Bohan*, 2002 WL 31962136, at *3-4 (C.D. Cal. Oct. 17, 2002); *Korsinsky v. Salomon Smith Barney Inc.*, 2002 WL 27775, at *6 (S.D.N.Y. Jan. 10, 2002); *Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 189 F. Supp. 2d 14, 18 (S.D.N.Y. 2001); *Shaev v. Claflin*, No. C 01-0009, 2001 WL 548567, at *5 (N.D. Cal. May 17, 2001); *Gutierrez v. Deloitte & Touche, LLP*, 147 F. Supp. 2d 584, 594-95 (W.D. Tex. 2001); *Gordon v. Buntrock*, No. 00-CV-303, 2000 WL 556763, *4 (N.D. Ill. Apr. 28, 2000).

14. States have diverged in their receptivity to such claims. *See Greenfield v. Fritz Cos., Inc.*, 98 Cal. Rptr. 2d 530, 538-39 & n.5 (Cal. Ct. App. 2000) (listing jurisdictions permitting "holding"-type claims and noting that Connecticut does not), *rev'd on other grounds sub nom. also Small v. Fritz Cos., Inc.*, 65 P.3d 1255, 1261 (2003). We do not have to determine whether Oklahoma law would permit recovery on such a theory, but only whether the putative state law claim falls within SLUSA's preemptive scope.

its ambit actual purchases or sales of stock *is* covered by SLUSA, a plaintiff may not avoid SLUSA's restrictions simply by alleging that a given misrepresentation caused him *both* to purchase and [to] hold a particular security." 292 F.3d at 1345. If it were otherwise, a plaintiff who is perfectly capable of pleading a claim under Rule 10b-5 could defeat SLUSA preemption (and thus evade the heightened requirements of the PSLRA) merely by alleging what is almost invariably true—that the misrepresentation which caused him to purchase the stock also caused him to retain it for some period of time. *See Riley*, 292 F.3d at 1345 ("[A]ll investors, by definition, hold their shares for at least some time after purchase.").

Moreover, a plaintiff who alleges the purchase and retention of securities in reliance on the misrepresentation but who forswears *damages* from the purchase and seeks only "holding damages" has still run afoul of SLUSA, which by its plain terms preempts claims "alleging" fraud in connection with the purchase or sale, and not merely claims seeking damages specifically traceable to the initial purchase. 15 U.S.C. § 78bb(f)(1); *see Prof'l Mgmt.*, 335 F.3d at 803 (holding that plaintiff "cannot avoid preemption by asserting it is only claiming damages suffered as a result of holding its stock" because "SLUSA's 'in connection with' requirement . . . is not limited to cases involving damages claimed as a result of the purchase or sale of securities [but]. . . . applies to any covered class action alleging an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security"). Grafting such a limitation onto the statute's plain terms would vitiate Congress's intent in enacting SLUSA, because plaintiffs who

have a federal remedy subject to the PSLRA's requirements could evade those requirements and bring a "strike suit" merely by purporting to forego some portion of their potential recovery. Congress forestalled such a move by prohibiting the maintenance of an action "alleging" fraud in connection with purchase or sale.

Dabit's amended complaint is generally careful to discuss only retention of a defined class of "ML stocks" during the relevant "class period." It is silent about when or how Dabit himself or any of his clients came to own any of these stocks, and charges only that Merrill Lynch made misrepresentations *subsequent* to Dabit's purchase. *See, e.g.*, Amended Compl. ¶ 2 (alleging that "ML, after Plaintiff's purchase of the ML Stocks ..., failed to advise Plaintiff of the fact of the decreasing values of the ML Stocks, and misrepresented to Plaintiff that the ML Stocks were worthy of holding in Plaintiff's or Plaintiff's clients' portfolio. . . ."). Dabit's putative class definition, however, fails to distinguish between those who came to hold an ML Stock before any relevant misrepresentation and those who purchased it in reliance on such representations. Dabit defines the class to include

> all . . . former or current account executives . . . who, while employed by [ML] . . . owned and continue to own one or more of the ML recommended securities identified in Exhibit A . . . or recommended such securities to their clients . . . and who suffered damages as a result of owning and holding such ML Stocks during th[e defined] time

> period, or who suffered damages as a consequence of the loss of clients due to ML's wrongful actions.

The class is elsewhere defined as all of those "persons who, while employed by [Merrill Lynch] as Retail Brokers, held individually or on behalf of the Classes' [sic] clients any of the ML Stocks during the period from December 1, 1999 through and including December 31, 2000 (the 'Class Period') and were damaged thereby." Damages suffered from "own[ing]" stocks during the class period include damages incurred by purchasing them during that period, and nothing in the complaint excludes such claims. The complaint elsewhere alleges that Merrill Lynch made "materially false and misleading statements" in 1999 and 2000—that is, throughout the class period—and that at least some of these false and misleading statements took the form of "buy recommendations." The two common-law causes of action incorporate all of the factual allegations in the complaint and stake the claims, respectively, on the breaches "in the manner described hereinabove" and through "[t]he wrongful acts alleged herein." Thus the complaint sweeps in the claims of brokers who purchased the stock during the class period in reliance on the misrepresentations and were damaged thereby.

Because the purchase of a stock in reliance on a misleading or fraudulent "buy" recommendation regarding the quality of that stock clearly satisfies the "in connection with" requirement as that phrase has been interpreted in the 10b-5 context, *see In re Ames Dept. Stores Inc. Stock Litigation*, 991 F.2d at 967; *Korsinsky*, 2002 WL 27775, at *5, the class as defined by Dabit includes those with preempted claims of purchase and retention. Lower courts

have diverged in their approach to complaints that do not *specifically* allege purchases in reliance on the misrepresentation but that define the class to include members with SLUSA-preempted claims, with results that are difficult to reconcile.[15] While we must read SLUSA's preemptive provisions narrowly to avoid interference with state police powers that Congress did not clearly intend, we must also give meaningful effect to SLUSA's remedial goals with respect to the class of purchaser/seller claims that *are* clearly preempted. *See Spielman*, 332 F.3d at 123 & n.5, 124. Where, as here, the complaint does not include sufficient information to permit the court to identify and separate preempted and non-preempted subclasses, we believe that the proper approach will ordinarily be to dismiss the entire

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15. *Compare. e.g., Shaev*, 2001 WL 548567 at *6 (holding that complaint that is "devoid of any allegations that make . . . a connection" between misleading conduct and purchase of stock escapes SLUSA preemption because "complaint does not indicate that the purported class chose to become ... shareholders based on any misrepresentations or omissions") *and Gutierrez*, 147 F. Supp. 2d at 594 *with Cape Ann Investors*, 296 F. Supp. 2d at 12 & n.6 (holding that complaint that offers no means of distinguishing those who purchased in reliance on misrepresentation from those who merely held is SLUSA preempted and noting that "[i]f a class representative could give purchasers and sellers a free ride by salting into the class a member or two with holding claims, it would be a rare case in which SLUSA applied at all") *and Korsinsky*, 2002 WL 27775, at *5 (finding that complaint defining class to include those who purchased subsequent to misleading "buy" recommendation was SLUSA preempted); *and Hardy*, 189 F. Supp. 2d at 18 (finding that complaint including class definition that "makes no effort to distinguish between customers who purchased before and after the stock rating allegedly became inaccurate" is preempted under SLUSA).

claim pursuant to SLUSA. Given the close relationship in most instances between a holding claim and the purchase of securities, and given SLUSA's manifest intent to preempt state-law claims alleging fraud in connection with an actual purchase, it is sensible to require a would-be "holding" lead plaintiff expressly to exclude from the class claimants who purchased in connection with the fraud and who therefore could meet the standing requirement for maintenance of a 10b-5 action. *See, e.g., Gordon*, 2000 WL 556763, at *3 (holding that holding class claim was not SLUSA-preempted because "plaintiff has gone to great lengths to stress that his complaint alleges misrepresentations *only* in the holding of securities" and complaint stated that as of the date on which *all* class members had already purchased stock, it was fairly valued and no class member had been deceived into holding the stock).

We therefore hold that when the class definition includes persons with SLUSA-preempted claims and does not permit the court to distinguish any non-preempted subclass, SLUSA requires that the claim be dismissed. Ordinarily such dismissal should be without prejudice in order to allow the plaintiff to plead a claim sounding only in state law if possible. We accordingly reverse so much of the district court's order as dismissed Dabit's and the putative class's claims for damages resulting from the owning and retention of the ML stocks and remand the case with instructions to dismiss those claims without prejudice.

Dabit's claim regarding commissions lost when customers abandoned Merrill Lynch following disclosure of its improper practices fares better. This claim, brought on

behalf of a putative class of brokers who "recommended [the defined ML stocks] to their clients" during the relevant class period and who "suffered damages as a consequence of the loss of clients due to ML's wrongful actions," relies not on the purchase or sale of any security in connection with the fraud, but on the absence of any such transactions by clients of the class members after the fraud was disclosed. Although we have not discovered another case discussing the effect of SLUSA on this apparently novel theory of recovery and express no opinion regarding its underlying merit,[16] it is clear that such a claim, by its very nature, does not allege fraud that "coincide[s]" with the sale or purchase of a security. *Zandford*, 535 U.S. at 825. It is therefore not preempted by SLUSA.

SLUSA prohibits the "maint[enance] in any State or Federal court" of any "covered class action" alleging fraud in the purchase or sale of a covered security under state law, 15 U.S.C. § 78bb(f)(1), and defines a "covered class action" as a "single lawsuit" or "group of lawsuits" brought on behalf of more than fifty persons and meeting other specified criteria, 15 U.S.C. § 78bb(f)(5)(B). These provisions might be read to suggest that where a single complaint contains claims that include allegations triggering preemption and other claims that do not, SLUSA prohibits maintenance of the entire action. On this reading, SLUSA would effectively preempt any state law claim conjoined in a given case with a securities fraud claim, whatever its nature. We assume,

16. As noted *supra* note 14, in considering whether a claim is preempted by SLUSA we do not consider the merit of the claim under state law. We therefore express no view on whether Oklahoma law would permit recovery on this theory.

however, that the historic police powers of the states are not preempted unless it was Congress's "clear and manifest purpose" to do so. *City of Milwaukee*, 451 U.S. at 316 (internal quotation omitted). Thus we decline to read SLUSA as such an imprecise instrument. *See, e.g.*, *Falkowski*, 309 F.3d at 1131-32 (affirming dismissal of preempted fraud claims but permitting maintenance of remaining contract claims). As we have already noted, SLUSA's language and legislative history indicate no intent to preempt categories of state action that do not represent "federal flight" litigation. We therefore reverse so much of the district court's order as dismissed the lost commissions claim and remand it for further proceedings.

B. IJG

IJG defined its putative class to include "[a]ll persons or entities who maintained retail brokerage accounts with [Merrill Lynch], and who paid a commission or fees to [Merrill Lynch]," and seeks to recover damages caused by the payment of those fees and commissions in contract and under Minnesota consumer protection law. Like Dabit, IJG studiously avoids any specific allegation of a purchase or sale of security in reliance on the biased research that it received. IJG argues that SLUSA's "in connection with" requirement is not satisfied because its claims relate solely to the contractual obligations and statutory and common-law duties owed by Merrill Lynch to its retail customers and thus "do not arise out of the purchase and sale of securities of companies that Merrill [Lynch] researched, but from the

purchase and sale of Merrill[Lynch]'s objectivity."[17] The objectivity that IJG claims it believed it was purchasing, however, was objectivity with respect to investment recommendations. The alleged breach of contract and violation of consumer protection statutes consisted of the provision of biased and misleading advice notwithstanding this alleged promise. We hold that, while the claims for flat annual fees are not preempted by SLUSA, the claims for commissions paid to Merrill Lynch are preempted because they necessarily involve allegations of a purchase or sale of securities "in connection with" this alleged misconduct.

In reaching this conclusion, we are guided generally by the analyses of some of our sister circuits. In *Behlen v. Merrill Lynch*, 311 F.3d 1087 (11th Cir. 2002), the Eleventh Circuit found that a plaintiff's claims were preempted by SLUSA where the object of the alleged fraud was to cause investment in inappropriate securities to which higher fees attached and the complaint requested damages for investments made in reliance on that advice. *Id.* at 1093-94. Under those circumstances, the fees and commissions paid were held to be "an integral part of the [underlying] transactions."

17. IJG also argues that its contract claim is not preempted because it does not allege any misrepresentation, omission, or deceptive device or practice in connection with that claim. This is plainly not the case, since the complaint alleges that the breach of contract consisted of the provision of "biased advice" regarding investments. The statutory claims explicitly allege misrepresentations regarding the objectivity of Merrill Lynch's advice; these alleged promises of objectivity, in turn, are only rendered misleading by the complaint's further allegation that Merrill Lynch produced and delivered biased research. This prerequisite for SLUSA preemption is therefore satisfied as to all of IJG's claims.

Id. at 1094. In *Dudek v. Prudential Securities, Inc.*, 295 F.3d 875 (8th Cir. 2002), the Eighth Circuit analogously found the plaintiffs' claims preempted where they alleged that the "defendants' misconduct caused plaintiffs to invest in inappropriate securities" and therefore to pay higher fees and incidental costs than necessary. *Id.* at 878. In contrast, in *Green*, the Eighth Circuit reached the opposite conclusion regarding SLUSA preemption where the plaintiff sought to recover flat fees paid for real-time online stock quotes that were in fact several hours old and "nothing in [plaintiff's] . . . complaint suggest[ed] that his cause of action ar[ose] from a sale or purchase of a security in reliance on information gained from [defendant's] real-time quote service." *Green*, 279 F.3d at 598-99. These cases suggest a logical distinction between claims that turn on injuries caused by acting on misleading investment advice, which (except in the case of holding or nonpurchase claims) necessarily allege a purchase or sale, and claims which merely allege that the plaintiff was injured by paying, independent of any given transaction, for a service that the broker failed to provide.

Consistent with this analysis, a few lower courts have analyzed claims similar to IJG's and have found that SLUSA preemption turns on whether some or all of the moneys paid for fraudulent or misleading advice were in the form of commissions tied to particular securities transactions. *See Rowinski v. Salomon Smith Barney, Inc.*, No. 3:02-CV-2014, 2003 WL 22740976, at *3 n.5 (M.D. Pa. Nov. 20, 2003) (distinguishing claim for flat monthly fee in *Green* from case at bar that sought commission fees, which were incurred only upon purchases or sales of securities and which claims the

court held were preempted); *McCullagh v. Merrill Lynch & Co.*, No. 01 Civ. 7322, 2002 WL 362774, at *4 (S.D.N.Y. Mar. 6, 2002) (finding preemption appropriate because even though "[p]laintiffs do not allege the purchase of specific stocks based on the recommendations, their allegations are clearly about the purchase of stocks because they seek disgorgement of commissions paid to [defendant]"); *see also Shaw v. Charles Schwab & Co.*, 2003 WL 1463842, at *4 (Cal. Sup. Ct. Mar. 7, 2003) (finding SLUSA dismissal appropriate where claim concerning defendant's alleged overcharging of commissions was necessarily dependent on underlying securities transactions because purchases and sales of securities triggered commissions in dispute). We find this logic compelling. The commissions giving rise to the claimed breach of contract and violations of the state consumer fraud laws only accrued when plaintiffs purchased or sold securities through Merrill Lynch. The claims for commissions therefore necessarily allege misstatements or omissions in connection with the purchase and sale of securities, and are preempted. *See Zandford*, 535 U.S. at 820, 825 (finding Rule 10b-5's "in connection with" requirement satisfied when "the securities transactions and breaches [complained of] . . . coincide[d]" and "were not independent events.").[18]

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18. In support of its claim IJG cites to the district court decision in *Spielman v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, No. 01-CV-3013, 2001 WL 1182927 (S.D.N.Y. Oct. 9, 2001), *appeal dismissed on other grounds*, 332 F.3d 116 (2d Cir. 2003), and to *Gray v. Seaboard Sec., Inc.*, 241 F. Supp. 2d 213 (N.D.N.Y. 2003). Those cases, however, are not helpful to IJG. In *Spielman*, the district court found that the transaction fees sought were not preempted by SLUSA because the alleged fraud concerned the commission structure itself, not the investment quality of securities. 2001 WL 1182927, at

(Cont'd)

Appendix A

The claims for the return of annual fees for unbiased research do, however, withstand SLUSA. An annual fee for services is paid whether or not the customer transacts on the account, and the misrepresentations inherent in the alleged nonperformance and statutory violations therefore do not necessarily "coincide[ ] with" a securities transaction, *Zandford*, 535 U.S. at 820; *compare Green*, 279 F.3d at 598 (finding no SLUSA preemption where plaintiff "allege[d] no sale or purchase of a covered security, only that he did not receive the type of information from [defendant] for which he believed he had contracted and paid twenty dollars monthly") *with Rowinski*, 2003 WL 22740976, at *3 n.5 (distinguishing claim for flat monthly fee in *Green* from case at bar that sought commission fees incurred only upon purchases or sales of securities).[19]

(Cont'd)

*4-5. That holding is suspect after *Zandford*, which held that Rule 10b-5 reaches misrepresentations that "coincide [ ]" with securities transactions whether or not they relate to the quality of any particular security, 535 U.S. at 820, but in any event it is quite different from the case at bar, where the plaintiffs implicitly allege that they transacted in securities and were thereupon charged for biased investment advice. Such allegations fall squarely within SLUSA's reach. In *Gray*, the court found that plaintiffs had alleged that defendants misrepresented the source of their investment advice, 241 F. Supp. 2d at 220, and further found that their breach of contract claim did not require them to allege any misrepresentation or omission, *id.* at 221. Here, in contrast, IJG alleges that the breach of contract and the statutory violations consisted precisely of the provision of misleading investment advice.

19. The SEC argues in its amicus brief that even annual fees claimed as damages, such as IJG's, should be preempted by SLUSA.

(Cont'd)

Appendix A

Neither the breach of contract claim nor the statutory claims for the return of these fees necessarily rest on any allegation

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(Cont'd)

The SEC's argument in this regard stems from its broader contention that "the 'in connection with the purchase or sale of' securities requirement is satisfied when a broker-dealer makes a misrepresentation or omission to a customer that relates to the customer's brokerage account regardless of whether the deception coincides with, or could be expected to influence, a securities transaction." Brief of the SEC, at 11. Although the meaning of the "in connection with" phrase under Rule 10b-5 itself is a subject on which we owe the views of the SEC *Chevron* deference, *Zandford*, 535 U.S. at 819-20, we are unable to regard this view as a reasonable construction of the Rule. *See Mead*, 533 U.S. at 229 (under *Chevron*, court is "obliged to accept the agency's position if . . . reasonable"); *Daniel*, 439 U.S. at 566 n.20 (noting that "[o]n . . . occasion[ ] . . . this Court has found it necessary to reject the SEC's [unreasonable] interpretation of various provisions of the Securities Acts."). On this view, the scope of the "in connection with" language is essentially unlimited, reaching even misrepresentations and omissions regarding an account that do not coincide with and have nothing to do with a securities transaction. In *Zandford*, the Supreme Court noted that its holding that the misrepresentation need not relate to the value of a security "does not transform every breach of fiduciary duty into a federal securities violation" and gave as one example of a claim that would not satisfy Rule 10b-5 embezzlement of funds from a client's account. *Zandford*, 535 U.S. at 825 n.4. The SEC's view is impossible to square with this uncontradicted dictum, and appears to be a more expansive reading than the view to which the Court deferred as reasonable in *Zandford*. *See id.* at 819-20. We therefore do not defer to the SEC's related view that a misrepresentation that does not coincide with any securities transaction satisfies the "in connection with" requirement so as to trigger SLUSA preemption.

of a purchase or sale of a security.[20] *See* Minn. Stat. §§ 8.31 subd. 3a, 325D.44, 325F.68-.71; *see generally Group Health Plan, Inc. v. Phillip Morris Inc.*, 621 N.W.2d 2, 5-6, 12-15 (Minn. 2001) (discussing requirements for maintenance of private action under consumer fraud statutes including Minn. Stat. § 325F.69); *Crenlo, Inc. v. Austin-Romtech*, No. A03-851, 2004 WL 948352, *3-5 (2004) (discussing elements of breach of contract claim under Minnesota law).[21] The district court therefore erred to the extent that it held that the claims for annual fees wrongfully charged by defendants were preempted by SLUSA. Accordingly, we affirm in part the dismissal of the complaint and the denial of IJG's motion for remand, but reverse the dismissal in part and vacate the judgment in part with instructions to the district court to grant IJG's motion for remand as to so much of the claim as seeks recovery on behalf of a putative class of those who paid annual fees.

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20. IJG's prayer for relief seeks the return of "funds wrongfully withheld, charged or retained" by Merrill Lynch as well as "actual damages including, but not limited to, attorneys fees, costs and expenses incurred in paying for valueless services." While this prayer could conceivably be read to encompass consequential damages stemming from investment losses incurred in reliance on Merrill Lynch's investment advice, that is not the most natural reading. IJG disavowed any such construction of its prayer for relief in its brief on this appeal. Plaintiffs are therefore judicially estopped from seeking any such damages on remand.

21. Again, we express no view on the viability of IJG's claims under Minnesota law.

Appendix A

CONCLUSION

We hold that (i) the meaning of "in connection with the purchase or sale of a . . . security" under SLUSA is the same as under § 10(b) of the Exchange Act and Rule 10b-5, (ii) the purchaser-seller rule affirmed in *Blue Chip* applies to the construction of "in connection with" under SLUSA, and (iii) under the particular circumstances presented in these cases, the actions here contain allegations of misrepresentations "in connection with" securities transactions and are partly preempted under SLUSA. For these reasons, the judgment below is AFFIRMED in part, VACATED in part and REMANDED for further proceedings consistent with this opinion.

APPENDIX B — OPINION AND DECISION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED APRIL 10, 2003

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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02 MDL 1484 (MP)

IN RE MERRILL LYNCH & CO., INC. RESEARCH REPORTS SECURITIES LITIGATION

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02 CV 4051 (MP)

CICCARELLI,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

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02 CV 8472 (MP)

DABIT,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

Appendix B

02 CV 9487 (MP)

IJG INVESTMENTS, L.P.,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

02-CV 4205 (MP)

SMITH,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

OPINION AND DECISION

Defendants have moved to dismiss the complaints pursuant to Fed. R. Civ. P. 12(b)(6) as preempted by the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA") (codified as 15 U.S.C. §§ 77p & 78bb(f)).

Appendix B

The four actions that are the subject of the instant motion purport to eschew federal claims and instead, assert "state law" claims based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court.

SLUSA provides that preempted causes of action may not be maintained in any state or federal court. *See* 15 U.S.C. §§ 77p(b) & 78bb(f)(1). SLUSA expressly preempts, and provides for the removal and dismissal of, any private class action seeking damages based on state statutory or common law that alleges misrepresentations or omissions of material facts or any manipulative or deceptive device or contrivance in connection with the purchase or sale of a nationally traded security.

The claims alleged in the four actions fall squarely within SLUSA's ambit.

Accordingly, the motions to dismiss all of the complaints are hereby granted and the motions to remand the *Ciccarelli*, *IJG Investments*, and *Smith* actions are denied.

So Ordered.

April 10, 2003

MILTON POLLACK
SENIOR UNITED STATES DISTRICT JUDGE

APPENDIX C — RELEVANT STATUTES AND REGULATIONS

15 U.S.C. § 77p

§ 77p. Additional remedies; limitation on remedies

(a) Remedies additional

Except as provided in subsection (b), the rights and remedies provided by this subchapter [15 U.S.C.A. § 77a et seq.] shall be in addition to any and all other rights and remedies that may exist at law or in equity.

(b) Class action limitations

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

(2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

(c) Removal of covered class actions

Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal

district court for the district in which the action is pending, and shall be subject to subsection (b).

(d) Preservation of certain actions

(1) Actions under State law of State of incorporation

(A) Actions preserved

Notwithstanding subsection (b) or (c), a covered class action described in subparagraph (B) of this paragraph that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

(B) Permissible actions

A covered class action is described in this subparagraph if it involves—

(i) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(ii) any recommendation, position, or other communication with respect to the sale of securities of the issuer that—

(I) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

(II) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

(2) State actions

(A) In general

Notwithstanding any other provision of this section, nothing in this section may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

(B) State pension plan defined

For purposes of this paragraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of the State or political

subdivision thereof, or by any agency or instrumentality thereof.

(3) Actions under contractual agreements between issuers and indenture trustees

Notwithstanding subsection (b) or (c), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

(4) Remand of removed actions

In an action that has been removed from a State court pursuant to subsection (c), if the Federal court determines that the action may be maintained in State court pursuant to this subsection, the Federal court shall remand such action to such State court.

(e) Preservation of State jurisdiction

The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

(f) Definitions

For purposes of this section, the following definitions shall apply:

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(1) Affiliate of the issuer

The term "affiliate of the issuer" means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

(2) Covered class action—

(A) In general

The term "covered class action" means—

(i) any single lawsuit in which—

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

(B) Exception for derivative actions

Notwithstanding subparagraph (A), the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

(C) Counting of certain class members

For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.

(D) Rule of construction

Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

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(3) Covered security

The term "covered security" means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 77r(b) of this title at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall not include any debt security that is exempt from registration under this subchapter pursuant to rules issued by the Commission under section 77d(2) of this title.

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15 U.S.C. § 77r(b)(1)(A)

(b) Covered securities

For purposes of this section, the following are covered securities:

(1) Exclusive Federal registration of nationally traded securities

A security is a covered security if such security is—

(A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the Nasdaq Stock Market (or any successor to such entities);

* * * *

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15 U.S.C. § 78bb(f)

(f) *Limitations on remedies*

(1) *Class Action Limitations.* No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or

(B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

(2) *Removal of Covered Class Actions.* Any covered class action brought in any State court involving a covered security, as set forth in paragraph (1), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to paragraph (1).

(3) *Preservation of Certain Actions.*

(A) *Actions Under State Law of State of Incorporation*

(i) *Actions Preserved.* Notwithstanding paragraph (1) or (2), a covered class action described in clause (ii) of this subparagraph

that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

(ii) *Permissible Actions.* A covered class action is described in this clause if it involves—

(I) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(II) any recommendation, position, or other communication with respect to the sale of securities of an issuer that—

(aa) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

(bb) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

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(B) *State Actions:*

(i) *In General.* Notwithstanding any other provision of this subsection, nothing in this subsection may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

(ii) *State Pension Plan Defined.* For purposes of this subparagraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of a State or political subdivision thereof, or by any agency or instrumentality thereof.

(C) *Actions Under Contractual Agreements Between Issuers and Indenture Trustees.* Notwithstanding paragraph (1) or (2), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

(D) *Remand of Removed Actions.* In an action that has been removed from a State court

pursuant to paragraph (2), if the Federal court determines that the action may be maintained in State court pursuant to this subsection, the Federal court shall remand such action to such State court.

(4) *Preservation of State Jurisdiction.* The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

(5) *Definitions.* For purposes of this subsection, the following definitions shall apply:

(A) *Affiliate of the Issuer.* The term "affiliate of the issuer" means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

(B) *Covered Class Action.* The term "covered class action" means—

(i) any single lawsuit in which—

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of

individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

(C) *Exception for Derivative Actions.* Notwithstanding subparagraph (B), the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

(D) *Counting of Certain Class Members.* For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.

(E) *Covered Security.* The term "covered security" means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933 [15 U.S.C.A. § 77r(b)], at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall not include any debt security that is exempt from registration under the Securities Act of 1933 [15 U.S.C.A. § 77a et seq.] pursuant to rules issued by the Commission under section 4(2) of that Act [15 U.S.C.A. § 77d(2)].

(F) *Rule of Construction.* Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

* * * *

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15 U.S.C. § 78j(b)

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

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17 C.F.R. § 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

APPENDIX D – BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION DATED JUNE, 2004

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

03-7499, 03-7458

SHADI DABIT,
on behalf of himself and all others similarly situated,

Plaintiff-Appellant.

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellee.

IJG INVESTMENTS L.P. and IRLYS GUY,
on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellee.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, ON ISSUES ADDRESSED

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Intentionally Omitted]

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

This brief is filed in response to the Court's request that the Securities and Exchange Commission, the agency principally responsible for administration and enforcement of the federal securities laws, file an *amicus curiae* brief addressing the Court's questions about the scope of the preemption provisions codified as Section 28(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(f), and Section 16(b) of the Securities Act of 1933, 15 U.S.C. § 78p(b), which were enacted as part of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").

STATEMENT OF THE CASE

1. *The Facts Alleged in the Complaints*

These consolidated class actions arise from defendant Merrill Lynch's alleged failure to provide objective research and stock recommendations to its customers, contrary to its promises to do so in exchange for the payment of annual fees and higher commissions. Both complaints rely on and incorporate the allegations in the affidavit filed by the New York Attorney General in support of his application for injunctive relief against Merrill Lynch under New York law. *See IJG* J.A. 12-14; *Dabit* J.A. 4, 43-80. The plaintiffs allege that, to promote business for its investment banking division, Merrill Lynch issued false and misleading analyst reports concerning publicly traded securities, and failed to disclose this conflict of interest between its research and investment banking divisions. *See IJG* J.A. 7-8, 11-13; *Dabit* J.A. 28.

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In *IJG*, the plaintiffs propose to represent a class of all Merrill Lynch customers who had retail brokerage accounts with Merrill Lynch and paid a commission or annual fees during the period covered by the state statute of limitations. *IJG* J.A. 15. The *IJG* plaintiffs assert common law claims for breach of contract and breach of the duty of good faith and fair dealing. *Id.* at 22. They contend that their contract claim does not depend on any allegation of misrepresentation, but alleges only that Merrill Lynch failed to deliver the unbiased research it promised, thereby breaching its contractual duty. *IJG* Br. at 41. They also assert claims under Minnesota's Consumer Fraud Act and Deceptive Trade Practices Act; in that context, they do allege that Merrill Lynch made misrepresentations about its research reports. *See IJG* J.A. 18-22.

In *Dabit*, the plaintiffs propose to represent two subclasses of Merrill Lynch employees. One subclass alleges that based on Merrill Lynch's biased research reports its members continued to hold securities in their personal portfolios that they otherwise would have sold; they seek unspecified damages for losses attributable to holding the securities. *Dabit* J.A. 25. The other proposed *Dabit* subclass consists of Merrill Lynch employees who, as a result of Merrill Lynch's biased research, lost clients and the commissions those clients would have paid in future transactions. *Id.* The *Dabit* plaintiffs assert claims for breach of fiduciary duty and breach of the covenant of good faith and fair dealing. *Id.* at 37-38.

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2. *The District Court Decision*

The *IJG* plaintiffs filed their complaint in Minnesota state court; the *Dabit* plaintiffs did so in Oklahoma state court. After Merrill Lynch removed the cases to federal court pursuant to SLUSA, the Judicial Panel for Multidistrict Litigation centralized these and a number of other cases "involv[ing] common questions of fact" in the United States District Court for the Southern District of New York. *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 223 F. Supp. 2d 1388, 1389 (J.P.M.L. 2002). On April 10, 2003, the district court (Pollack, J.) dismissed the complaints in *IJG* and *Dabit*, and two other cases in which appeals were not taken, as preempted by SLUSA. *See Dabit* J.A. 213; *IJG* J.A. 34.

The district court's order did not address the specific arguments the plaintiffs made in asserting that their claims were not preempted by SLUSA. The court instead focused on the fact that the complaints referred to the same factual allegations of biased research reports relied on in the federal securities fraud actions with which they had been centralized. *Id.* For that reason, the court concluded, "[t]he claims alleged in the [two] actions fall squarely within SLUSA's ambit." *Id.*

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ARGUMENT

In requesting a brief from the Commission, the Court posed four questions concerning the scope of SLUSA. First, the Court asked whether, in requiring that a preempted action allege wrongdoing "in connection with the purchase or sale" of covered securities under SLUSA, Congress intended the "in connection with" requirement to have the same meaning as the identical term used in the antifraud provision in Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b). Second, the Court asked whether the "purchaser-seller rule of standing or otherwise enunciated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), should be adopted for SLUSA." Third, the Court asked "[w]hether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5." Finally, the Court asked whether four scenarios, based on various claims in these cases, satisfy the "in connection with" requirement.

A. SLUSA Was Adopted to Prevent the Use of State Law Actions to Avoid the Requirements of the Federal Private Securities Litigation Reform Act.

SLUSA represented a significant change in the relationship between the federal securities laws and state law. When Congress adopted the Securities Act in 1933 and the Exchange Act in 1934, it intended to supplement rather than supplant state "blue sky" laws, many of which predated the federal statutes by more than twenty years. *See* Testimony of the U.S. Securities and Exchange Commission Concerning S. 1260, the Securities Litigation Uniform Standards Act of 1997 before the Subcommittee on Securities Committee on

Banking, Housing and Urban Affairs, 105th Cong. 2 (Oct. 29, 1997) (statement of the Commission). As originally enacted, neither statute preempted any state law and, to the contrary, specifically preserved all other remedies available under state or federal law. *Id.* at 2-3.

This was still true when, in 1995, Congress adopted the Private Securities Litigation Reform Act ("PSLRA"). That statute was enacted to filter out potential strike suits by, among other things, imposing more stringent pleading requirements and mandatory discovery stays for federal securities fraud actions. *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 332 F.3d 116, 122 (2d Cir. 2003).

After it enacted the PSLRA, Congress became concerned that plaintiffs were evading PSLRA requirements, particularly the heightened scienter pleading standard and discovery stay, by filing suits under state law in state courts. *See* SLUSA, Pub. L. No. 105-353, § 2(2), 112 Stat. 3227. In 1998, therefore, Congress enacted SLUSA, and stated in the legislation that it was doing so to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]." *Id.* Sec. 2(5). *See also Green v. Ameritrade, Inc.*, 279 F.3d 590, 595 (8th Cir. 2002) (SLUSA prevents plaintiffs from evading federal protections against "abuse litigation" by filing suit in state, rather than federal courts).

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SLUSA altered the federal-state relationship by largely preempting state law securities fraud class actions.[1] Section 28(f) of the Exchange Act provides that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging * * * [either] a misrepresentation or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance", "in connection with the purchase or sale of a covered security."

Although the PSLRA had not imposed a heightened pleading requirement on private actions under the Securities Act and there was no perceived "flight" of private actions under the Securities Act from federal to state courts, SLUSA nevertheless also amended the Securities Act to provide, in Section 16(b), that no class action based on state law may be maintained in state or federal court by any private party alleging "an untrue statement or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance," "in connection with the purchase or sale of a covered security."

SLUSA has been held by this Court and others to be a statute of "complete preemption," meaning that for any claim that falls within its scope only a federal claim exists and the

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1. Two years earlier, in the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in part at 15 U.S.C. § 77r, 80a), Congress for the first time preempted some state securities regulation and divided the responsibility for securities registration and investment adviser registration between the Commission and the states.

complaint must be dismissed if the action has been brought only under state law. *See Spielman*, 332 F.3d at 123-124; *Green*, 279 F.3d at 596.

B. The Phrase "In Connection With The Purchase Or Sale" Of Securities, as Used in SLUSA, Has The Same Broad Meaning as In Section 10(b) of the Exchange Act.

The Court's first question is whether decisions interpreting the phrase "in connection with the purchase or sale" of securities in Section 10(b) of the Exchange Act and Rule 10-5 are applicable to the interpretation of that same phrase in SLUSA's preemption provisions. The Commission recently addressed this question in an *amicus* brief filed in *Gray v. Seaboard Securities, Inc.*, No. 03-7184 (2d Cir.) (brief filed October 6, 2003) ("*Gray* Br."). As we discussed there, the phrase "in connection with the purchase or sale" found in SLUSA has been correctly construed by courts to mean the same thing as the identical phrase found in Section 10(b) of the Exchange Act. As the Court of Appeals for the Eleventh Circuit has stated:

> In enacting SLUSA, . . . Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention. In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired

> settled, and widely-acknowledged meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 [sic] lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the purchase or sale of a covered security" to have the same meaning in SLUSA that it has in Section 10b-5 [*sic*].

Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1342-43 (11th Cir.), *cert. denied*, 537 U.S. 950 (2002); *accord Green*, 279 F.3d at 597; *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1129 (9th Cir. 2002), *opinion amended*, 320 F.3d 905 (9th Cir. 2003). Moreover, the state law cases Congress wanted to preempt in SLUSA were those that were being brought in order to avoid the PSLRA requirements that, in turn, had been enacted largely because of abusive Section 10(b) actions. Adopting for SLUSA purposes a construction of the term that is more restrictive than the definition applied under Section 10(b) would mean that litigants could continue to bring some cases under state law rather than being forced to sue under Section 10(b) and its attendant constraints.

In general, courts have recognized that the meaning of the Section 10(b) phrase "in connection with the purchase or sale of any security" is "as broad and flexible as is necessary to accomplish the statute's purpose of protecting investors." *See SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993), and cases discussed therein. This Court has long recognized that the "in connection with" requirement in Section 10(b) is satisfied when a misrepresentation is made

"in a manner reasonably calculated to influence the investing public." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (*en banc*). *Accord*, *McGann v. Ernst & Young*, 102 F.3d 390, 392-96 (9th Cir. 1996); *Britt v. Cyril Bath Co.*, 417 F.2d 433, 435-36 (6th Cir. 1969).

By its plain terms the phrase "in connection with the purchase or sale" of a security requires only that there be a nexus or relationship between the fraud and a securities transaction. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (paraphrasing "in connection with" as "touching"); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (quoting "touching" language from *Bankers Life* with approval); *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990) ("some nexus"); *Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 593 (7th Cir. 1984) ("some nexus but not necessarily a direct and close relationship"); *Brown v. Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) ("a nexus"). The necessary connection therefore exists when, among other situations, "the proscribed conduct and the sale are part of the same fraudulent scheme," *Alley v. Miramon*, 614 F.2d 1372, 1378 n. 1 1 (5th Cir. 1980) (Wisdom, J.), such as when the fraud and the sale of securities "coincide," *SEC v. Zandford*, 535 U.S. 813, 822 (2002).

We believe that under these principles, the "in connection with the purchase or sale of" securities requirement is satisfied when a broker-dealer makes a misrepresentation or omission to a customer that relates to the customer's brokerage account regardless of whether the deception coincides with, or could be expected to influence, a securities transaction. This is so because any misrepresentation or

omission relating to an account should ordinarily be regarded as inherently "in connection with the purchase or sale of any security." The very purpose of a brokerage account is to buy and sell securities. Thus, any deception that could affect the decision of the customer to open a brokerage account, and to do so on the terms specified in the account agreement, closely touches on securities transactions. *See Gray* Br. at 12 n.9; *see also* SEC Amicus Br. at 13-14, filed in 1996 in *Bissell v. Merrill Lynch & Co.*, 157 F.3d 138 (2d Cir. 1998).

There is no merit to the plaintiffs' claim here (*see IJG* Br. at 28) that only misrepresentations about particular securities bought or sold by a plaintiff, or that induce a particular purchase or sale, meet the "in connection with" requirement, while misrepresentations about the general character of research provided by a brokerage firm or that affect the commissions charged on securities trades are excluded. That argument no longer can be made after the Supreme Court's decision in *Zandford*, 535 U.S. at 821, which expressly rejected the contention that fraud must pertain to the value of a security or "manipulation of a particular security" in order to meet the "in connection with" requirement. This Court had earlier rejected such a limitation on the scope of the "in connection with" language when it held in *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 537 (2d Cir. 1999), that the statutory language encompassed an alleged misrepresentation about when the proceeds of a securities sale would be available to the customer.

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C. Three Of the Four Situations Identified By The Court Involve Misrepresentations "In Connection With The Purchase Or Sale" Of Securities.

Applying the foregoing view of the "in connection with" language in SLUSA, we believe that the first three scenarios identified by the Court in its request satisfy the "in connection with" requirement, while the fourth scenario does not. The Court asked:

> Where a brokerage allegedly issued intentionally false and biased research reports to garner investment banking business, whether the following state law claims arising from that activity meet SLUSA's 'in connection with' requirement:
>
> > (a) claims brought by the brokerage's clients for annual flat fees paid to the brokerage for unbiased investment research, which fees are not triggered by any actual purchases or sales of securities;
> >
> > (b) claims brought by the brokerage's clients for commissions fees paid to the brokerage for investing in securities recommended by the biased research;
> >
> > (c) claims brought by the brokerage's broker-employees for investment losses suffered in retaining securities as a result of

the brokerage's falsely touting the securities' values; and

(d) claims brought by the brokerage's broker-employees for the loss of future commissions to be paid by their clients who left the brokerage as a result of the biased research?

As to hypothetical (a), it is reasonable to expect that Merrill Lynch customers would be influenced, both in deciding to open accounts at the firm and later in making securities transactions, by the firm's false statements that its recommendations were objective. The very reason that a customer decides to pay additional fees in exchange for objective stock recommendations is to obtain information on which to decide whether to buy and sell securities. Even if a customer does not in fact later engage in securities transactions in the account, the deception in causing the account to be opened is so inherently related to securities transactions that it satisfies the "in connection with the purchase or sale" requirement in SLUSA. *See, e.g., McCullagh v. Merrill Lynch & Co.*, 01-Civ-7322-DAB, 2002 WL 362774, at *4 (S.D.N.Y. Mar. 6, 2002) (similar allegations of biased research satisfy the "in connection with" language of SLUSA because the alleged misrepresentation concerns "the quality of investment advice"); cf. *Rowinski v. Salomon Smith Barney, Inc.*, No. 3:02cv2014, 2003 WL 22740976, at *3 (M.D. Pa. Nov. 20, 2003) ("plaintiff would not be concerned with the accuracy of SSB's analyst reports unless he intended to, and did, in fact, rely on them in deciding to purchase or sell stock").

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An even closer connection exists between the alleged fraud and securities transactions under hypothetical (b). Under that hypothetical the fees paid as a result of the deceptive research claims are triggered if and when the customer makes an actual purchase or sale of securities. It seems apparent that a fraudulently induced fee that is paid as part of a securities transaction is a fraud "in connection with" that transaction. *See Rowinski*, 2003 WL 22740976, at * 3 (concluding on similar facts that alleged fraud was "in connection with the purchase or sale" of securities in part because "[a] commission is earned by SSB only when a customer purchases or sells securities").

The Commission also believes that hypothetical (c) would come within the "in connection with the purchase or sale" language in SLUSA. Even though the first proposed *Dabit* subclass consists only of Merrill Lynch employees, their claim is no different than that of any investor who continued to hold securities based on misrepresentations – their status as employees is irrelevant.

The final claims, described in hypothetical (d), fall outside the "in connection with the purchase or sale" language, and therefore outside SLUSA's preemption provisions. The premise of this hypothetical is that the customers to which the misrepresentations were made stopped doing business with the broker after they learned of the biased research. Because the customers were made aware of the falseness of the misrepresentations, the continuing effect of the misrepresentations necessarily ended. The broker-employees' claims, therefore, are not based on misrepresentations that could be part of a fraudulent scheme

in which the misrepresentations played a part; they did not coincide with, nor might they have influenced, any possible purchase or sale of securities. To the contrary, the employees' claims necessarily depend on the fact that the former customers have learned of the misrepresentations and will not in the future engage in securities transactions through Merrill Lynch, where the plaintiffs are employed. The claims in this hypothetical simply have no factual or logical link to the alleged deception.

That the first three hypotheticals satisfy the "in connection with" requirement does not, however, mean that private plaintiffs making these claims can sue under Section 10(b) and Rule 10b-5. A private plaintiff suing under these provisions only has standing to sue if they allege that they either purchased or sold securities as a result of the alleged falsehood. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) ("*Blue Chip*"). Thus, to the extent plaintiffs alleging claims under hypotheticals (a) and (c) did not buy or sell securities as a result of the alleged fraud, they could not sue under Section 10(b) and Rule 10b-5. This does not mean, however, that the claims do not satisfy the "in connection with" requirement. As this Court has recently held, it is error to "conflate the issue of standing" under *Blue Chip* "with the question of whether the 'in connection with' requirement has been met," since these are "two distinct inquiries." *Ontario Public Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 2004 WL 1110496, *6, 379 F.3d 27 (2d Cir. May 19, 2004).

Appendix D

D. SLUSA Applies to Preempt State Law Actions Even if the Actions Do Not Meet the Purchaser/Seller Standing Requirement of *Blue Chip*.

The next question is whether the purchaser-seller rule enunciated in *Blue Chip* (originally articulated in this Court's decision in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952)), should be adopted under SLUSA. Some state law actions for securities fraud do not contain this requirement. *See, e.g., Small v. Fritz Cos.*, 65 P.3d 1255, 1260-1261, 1263 (Cal. 2003). If SLUSA contains a purchaser/seller limitation, those state law actions would not be preempted.

The courts that have considered the issue have held that SLUSA does not preempt actions that do not meet the purchaser/seller requirement. They reason that the purchaser/seller limitation under Section 10(b) is based on a construction of the phrase "in connection with the purchase or sale" of securities, and that the use of the same phrase in SLUSA carries with it the same construction. For example, in *Riley*, 292 F.3d at 1342-43 the Eleventh Circuit held:

> In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the

> purchase or sale of a covered security" to have the same meaning in SLUSA that it has in § 10b-5.

Id. (emphasis in original). *Accord*, *Green*, 279 F.3d at 598; *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 595 (W.D. Tex. 2001).[2]

These decisions misapprehend the relationship between the purchaser/seller requirement and the "in connection with" element in Section 10(b). The *Blue Chip* Court began its analysis by noting that when this Court articulated the purchaser/seller limitation in *Birnbaum*, it relied on the facts that

> both § 10(b) and Rule 10b-5 proscribed only fraud "in connection with the purchase or sale" of securities, and * * * the history of § 10(b) revealed no congressional intention to extend a private civil remedy for money damages to other than defrauded purchasers or sellers of securities,

---

2. *See also Gordon v. Buntrock*, 2000 WL 556763, at *4 (N.D. Ill. Apr. 28, 2000) (Mem. Op.); *Simon v. Internet Wire, Inc.*, 2001 U.S. Dist. LEXIS 4086, Fed. Sec. L. Rep. (CCH) ¶ 91,408 (C.D. Cal. Apr. 3, 2001); *Burns v. Prudential Sec.*, 116 F. Supp. 2d 917, 922-23 (N.D. Ohio 2000); *Shaev v. Claflin*, 2001 U.S. Dist. LEXIS 6677, Fed. Sec. L. Rep. (CCH) ¶ 91,452 (N.D. Cal. May 17, 2001); *Shaw v. Charles Schwab & Co., Inc.*, 128 F. Supp. 2d 1270, 1272 (C.D. Cal. 2001); *Hines v. ESC Strategic Funds, Inc.*, 1999 U.S. Dist. LEXIS 15790, No. 3:99-0530, 1999 WL 1705503, at *6 (M.D. Tenn. Sept. 17, 1999); *Lalondriz v. USA Networks*, 54 F. Supp. 2d 352, 353-54 (S.D.N.Y.), *adhered to on reconsideration by* 68 F. Supp. 2d 285, 286 (S.D.N.Y. 1999).

> in contrast to the express civil remedy provided by § 16(b) of the 1934 Act

421 U.S. at 731, citing *Birnbaum*, 193 F. 2d at 463-464. The Supreme Court stated that "the wording of § 10 (b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large." 421 U.S. at 733 n.5. The Court also noted that Congress twice rejected Commission proposals to add language to Section 10(b) referring to "any attempt to purchase or sell, any security," *id.* at 732. The Court concluded (*id.* at 733):

> The longstanding acceptance by the courts, coupled with Congress' failure to reject *Birnbaum*'s reasonable interpretation of the wording of 10 (b), wording which is directed toward injury suffered "in connection with the purchase or sale" of securities, argues significantly in favor of acceptance of the *Birnbaum* rule by this Court. *Blau v. Lehman*, 368 U.S. 403, 413 (1962).[3]

---

3. The Court also noted that other portions of the securities laws suggested a purchaser/seller requirement. In contrast to Section 10(b), Section 17(a) applies to "offers" to sell securities, showing that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly." *Id.* at 734. It also observed that the requirement in Section 28(a) of the Exchange Act, which requires that a plaintiff prove "actual damages," would counsel against allowing suits where the

(Cont'd)

The *Blue Chip* Court went on, however, to state: "[h]aving said all this, we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 738. The Supreme Court held, rather, that in construing a judicially inferred private right of action, it would be

> proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

Id. at 737. Turning to these policy considerations, the Court stated (*id.* at 743, emphasis added) that "[t]he *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by *violations* of Rule 10b-5, and to that extent it is undesirable." In concluded, however, that this disadvantage was outweighed by the benefits of the rule in the elimination of cases involving great difficulties of proof and potential for vexatiousness (*id.* at 739-744). In short, although the Court concluded that the purchaser/seller requirement was consonant with the statutory language and structure,

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(Cont'd)

alleged injury "largely conjectural and speculative." *Id.* at 734-735. And it noted that the express non-derivative remedies in the Securities Act (Sections 11 (a) and 12) and Exchange Act (Sections 9 and 18) all contain a requirement that the plaintiff purchase or sell securities. *Id.* at 736.

it indicated that if there were no net policy advantage to the purchaser/seller rule, it would not have endorsed it. *See* 421 U.S. at 738-39. Yet the policy concerns that led to the adoption of the rule under Section 10(b) do not appear to-apply under SLUSA.[4] As applied under Rule 10b-5, the purchaser/seller rule serves to eliminate lawsuits that involve difficult issues of proof and are vexatious. Were the same rule to apply under SLUSA it would have the opposite effect, in that it would allow lawsuits with precisely these vexatious characteristics to go forward. In addition, adopting a purchaser/seller rule would make preemption turn on whether a state had a purchaser/seller requirement for its securities fraud actions. Rather than enforcing a uniform national standard, as SLUSA was intended to do, the application of the Act would turn on what standing rule a state happened to recognize.

Some courts that have applied a purchaser/seller limitation under SLUSA have nonetheless done so in part based on the view that to do so is consonant with one policy reason for the *Blue Chip* decision. The *Blue Chip* Court said that the disadvantage of denying relief to a victim of securities fraud "is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." *Id.* at 738 n.9. These courts have reasoned that to apply SLUSA to preempt such state law suits would undercut this rationale.

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4. The Commission takes no position on whether the Court could adopt a purchaser/seller limitation under SLUSA as a matter of policy. In *Blue Chip*, the Court held that it could consider policy because it was construing the parameters of an implied cause of action that had been judicially created in the first place. *See* 421 U.S. at 737.

See Riley, 292 F.3d at 1344-1345; *Green*, 279 F.3d at 598; *Guttierez*, 147 F. Supp. 2d at 595. It is hardly clear, however, that the Congress that adopted SLUSA, which radically altered the relationship between federal and state law concerning securities fraud, entertained a similarly benign view of state law actions. To believe that would require a conclusion that while Congress saw fit under SLUSA to preempt most state law causes of action as a vexatious end-run around federal limitations on private securities law suits, it nevertheless exempted from preemption one state law cause of action the *Blue Chip* Court saw as a particularly vexatious form of litigation.

Adoption of the purchaser/seller rule for SLUSA poses other potentially serious problems. If the purchaser/seller rule is incorporated into the "in connection with" language, that same limitation arguably would apply to the Commission and the United States in civil and criminal enforcement cases under Section 10(b), since those also must meet that statutory element. Yet the Court has been explicit, in *Blue Chip* and afterwards, that the purchaser/seller requirement applies only to private securities fraud actions seeking damages, and not to government enforcement actions. *See Blue Chip*, 421 U.S. at 751 n.14 ("the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under § 10(b) and Rule 10b-5"); *United States v. Naftalin*, 441 U.S. 768, 774 n.6 (1979) (*Blue Chip* is "inapplicable" to a criminal prosecution).

Application of a purchaser/seller limitation to government actions could have a damaging effect on the enforcement of the securities laws in cases where it could

not be shown that some investor purchased or sold securities. Hypothetical (c), discussed above, presents such a scenario. For this reason, as noted, this Court has long required, to meet the "in connection with" requirement, only that it be shown that a fraudulent statement was made "in a manner *reasonably calculated* to influence the investing public * * *." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (emphasis added).

Finally, the *Blue Chip* Court recognized that even in a private action, a violation of Section 10(b) could exist without a purchase or sale of securities. The Court stated that "[t]he *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by *violations of Rule 10b-5*, and to that extent it is undesirable." 421 U.S. at 743 (emphasis added). If, absent a purchase or sale, the "in connection with" requirement was not met, the Court could not have believed that violations of Section 10(b) could have occurred, since an essential element of Section 10(b) would be absent.

We note, finally, that were SLUSA to apply only where there is an allegation of a purchase or sale of securities, the preemption of class actions would become a complex question. Even if the action only alleges that it is brought on behalf of persons who held securities during the class period, some of those persons will in fact have bought or sold the securities during the period. Would the entire class action be excluded from SLUSA preemption because there is no allegation of a purchase or sale, or will the court have to go behind the pleadings to ascertain if any of the class members in fact have purchaser/seller standing? This potential problem does not exist under the construction of SLUSA we propose here.

E. SLUSA Preempts State Law Actions Even Under Certain Circumstances Where They Could Not Be Brought Under Section 10(b) And Rule 10b-5.

The Court also asks "[w]hether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5." This question is broad because there are a number of reasons why an action might not be sustainable under Section 10(b). One would be that there is no misrepresentation or other deception. The clear language of SLUSA, however, requires that the action allege a misrepresentation or misleading omission or other deception. Thus, the Commission does not believe the defendants are correct that a pure breach-of contract claim – with no allegation of misrepresentation - comes within the terms of the preemption provisions. It seems clear from the face of the statute that claims containing *no* allegations of misrepresentation, untrue statements or any other form of fraud, such as claims alleging only a breach of contract or breach of fiduciary duty – are not preempted by SLUSA.

Another reason a Section 10(b) claim might fail would be because the fraud was not "in connection with the purchase or sale of securities." Since, however, as discussed above, the "in connection with" requirement in SLUSA is co-extensive with that in Section 10(b), a claim that failed for this reason also would fail to meet the "in connection with" requirement in SLUSA, and would not be preempted. A private Rule 10b-5 action might also fail because the plaintiff lacks *Blue Chip* standing; yet because SLUSA contains no such limitation, that fact would not preclude SLUSA preemption.

Appendix D

The plaintiffs take the position (*see IJG* Br. at 19-20, 33) that SLUSA preempts only "traditional" or "typical" securities fraud, and, thus, that SLUSA does not preempt claims that would not state a claim under Section 10(b) for lack of an allegation of scienter (that is, that the deception was either knowing or reckless), which is an element of an action under Section 10(b) of the Exchange Act and Rule 10b-5. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976); *see also Aaron v. SEC*, 446 U.S. 680, 696 (1980). *See Dabit* Reply Br. at 4-5 (relying on *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 110 (2d Cir. 2001)).

We believe, however, that the statute's language makes clear that SLUSA preemption does not require an allegation of scienter.[5] Section 28(f) of the Exchange Act preempts allegations that the defendant used a "manipulative or

5. There is scant judicial authority on the issue. The only federal court of appeals to address the issue has held, after noting that Section 16(b) of the Securities Act preempts non-scienter-based causes of action, that scienter is not required for SLUSA preemption. *See Riley v. Merrill Lynch Pierce, Fenner & Smith. Inc.*, 292 F.3d 1334, 1345-1346 (11th Cir.), *cert. denied,* 537 U.S. 950 (2002); *see also In re Worldcom*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003) (similar). Some district courts, with little analysis, have concluded that SLUSA preempts only allegations of fraud with scienter, apparently accepting the view that Congress intended to reach only claims analogous to Section 10(b) claims. *See,, Green v. Ameritrade. Inc.*, 120 F. Supp. 2d 795, 798 (D. Neb. 2000), *aff'd on other grounds*, 279 F.3d 590 (8th Cir. 2002); *Burns v. Prudential Sec.*, 116 F. Supp. 2d 917, 923-24 (N.D. Oh. 2000).

deceptive device or contrivance" or made a "misrepresentation or omission of a material fact," "in connection with the purchase or sale of a covered security." Section 16(b) of the Securities Act replaces the first clause with a requirement that the defendant made "an untrue statement or omission of a material fact" but otherwise is identical to Section 28(f).

These terms are drawn from essentially identical language contained in Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. The Supreme Court has held that the term "manipulative or deceptive device or contrivance" requires scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 ("the words 'manipulative,' 'device,' and 'contrivance' [terms used in Section 10(b) of the Exchange Act] [are] terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence"). On the other hand, the term "untrue statement or omission to state a material fact" does not. *See Aaron*, 446 U.S. at 696 (holding that "untrue statement" or "omission of a material fact" language is "devoid of any suggestion whatsoever of a scienter requirement"). As to the term, "misrepresentation * * * of a material fact," the *Aaron* Court noted that in *Hochfelder*, it

> pointed out that the similar language of Rule 10b-5(b) "could be read as proscribing . . . any type of material misstatement or omission . . . that has the effect of defrauding investors, whether the wrongdoing was intentional or not."

Id., quoting *Hochfelder*, 425 U.S. at 212.[6] Although Section 28(f) uses the term "misrepresentation" rather than "misstatement" (the word used in Rule 10b-5(b)), we do not think the terms are significantly different. The common understanding of the term "misrepresentation" is that it does not require intent. The common law recognizes, for example, that actionable "misrepresentation" may be the product of negligence. *See, e.g.*, Restatement (Second) of Torts § 304 (2004). In short, since SLUSA applies where any of these forms of deception is alleged, the language of SLUSA does not on its face require that the plaintiff's allegations state a scienter-based claim, as required under Rule 10b-5.

The imposition of a scienter requirement would also be inconsistent with SLUSA's principal purpose. In adopting SLUSA, Congress stated, as part of the findings in the legislation itself, that

> in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

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6. Although the *Hochfelder* Court conceded that the language in Rule 10b-5 could support liability for negligence, Rule 10b-5 requires a showing of scienter because it is constrained by the narrower language of Section 10(b). *See* 425 U.S. at 214.

SLUSA, Pub. L. No. 105-353, § 2(5), 112 Stat. 3227. While part of Congress's concern was the procedural constraints on class action litigation, another concern was compelling compliance with the PSLRA's heightened scienter pleading standard, which requires plaintiffs in Rule 10b-5 cases to allege scienter with greater specificity than many courts had previously required. *See* 15 U.S.C 78u-4(b). To the extent that migration toward state courts had been fueled by this requirement, it would have been because plaintiffs found it difficult, after the PSLRA, to make an adequate claim of scienter in Rule 10b-5 cases. If it were to be held that SLUSA does not apply to a case which cannot, for lack of an allegation of scienter, be brought under Rule 10b-5, this objective of SLUSA would be largely undercut. SLUSA could not compel compliance with the PSLRA's scienter pleading standard, since it simply would not apply to any class action complaint that could not comply with the PSLRA standard. Congress could not have intended such a self-defeating result.[7]

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7. Nothing in the language of SLUSA suggests that any of the other requirements of a private Rule 10b-5 action - such as statute of limitations, reliance, loss causation - must be met before SLUSA preemption will apply.

Appendix D

CONCLUSION

For the foregoing reasons, the Court should rule in accordance with the positions urged in this brief.

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In The

Supreme Court of the United States

MERRILL LYNCH, PIERCE,
FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself
and all others similarly situated,

Respondent.

**On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Second Circuit**

BRIEF IN OPPOSITION

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STATEMENT OF THE CASE

A. Introduction

This action arises out of an employers' breach of its fiduciary and contractual duties owed to its employees. Respondent Shadi Dabit ("Dabit" or "Respondent") is a former employee of Petitioner, Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch" or "Petitioner"). Dabit was employed as a "Financial Associate," more commonly referred to as a broker. Dabit instituted this putative class action lawsuit on April 26, 2002, on the heels of a much publicized investigation conducted by the New York State Attorney General, Elliott Spitzer. The investigation found, among other things, that Merrill Lynch engaged in a systemic practice of issuing positive securities analysts' recommendations to attract and curry favor with investment banking clients and culminated in Merrill Lynch paying a $100 million fine. *See* First Amended Class Action Complaint. The Attorney General's investigation found that Merrill Lynch's analysts routinely publicly issued glowing recommendations for stocks in companies for which Merrill Lynch provided or aspired to provide investment banking services while privately believing that such stocks were poor investments. *Id.* As detailed in an Affidavit submitted by an Assistant Attorney General of the State of New York, Merrill Lynch withheld material information from its brokers about the stocks it was touting, including the fact that Merrill Lynch's analysts really thought that these stocks were, among other things, "crap," "shit," "piece[s] of junk," "dog[s]," or "going a lot lower." *Id.*

In his Amended Complaint, Dabit, on behalf of himself and other similarly situated current and former Merrill Lynch brokers, alleged claims for breaches of fiduciary

duty and the covenants of good faith and fair dealing implied in the brokers' employment contracts with Merrill Lynch. *Id.* Dabit sought damages in the nature of (1) lost commissions from clients who closed their Merrill Lynch accounts after suffering losses from investing in Merrill Lynch recommended securities, and (2) losses resulting from holding Merrill Lynch recommended securities in their personal accounts, as a result of Merrill Lynch's wrongful conduct. *Id.* The facts of this case and the allegations of the Amended Complaint are more fully set forth in the Opinion below, *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2nd Cir. 2005); Petitioner's Appendix ("Pet. App.") at 1a-52a, and are incorporated herein by reference.

After the United States District Court for the Southern District of New York dismissed Respondent's claims as pre-empted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Respondent appealed.

B. The Opinion of the United States Court of Appeals for the Second Circuit

In a lengthy opinion, the United States Court of Appeals for the Second Circuit affirmed in part and vacated in part the judgment below and remanded for further proceedings consistent with its Opinion. *Dabit v. Merrill Lynch*, 395 F.3d 25, 28, 50-51 (2nd Cir. 2005). Specifically, the Court held:

> (i) the meaning of "in connection with" under SLUSA is coterminous with the meaning of the nearly identical language of §10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Pub. L. No. 73-291, 48 Stat. 881, 891 (1934) (codified at 15 U.S.C. §78j(b)) and its corresponding Rule

> 10b-5, 17 C.F.R. §240.10b-5, and (ii) the purchaser-seller rule of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), applies as a limit on SLUSA's "in connection with" requirement such that SLUSA does not pre-empt claims that do not allege purchases or sales made by the plaintiff or the alleged class members.

Id. at 28; Pet. App. at 3a-4a. More particularly, the Court affirmed the judgment below to the extent it found Dabit's "holding" claims pre-empted for the reason that they "satisf[ied] SLUSA's conditions requiring pre-emption because they contain implicit allegations of purchases made by plaintiffs and putative class members." *Id.* The Court, however, vacated "so much of the judgment as dismissed Dabit's lost-commission claim and dismissed the remaining claims with prejudice, and remand[ed] to the district court to dismiss these claims without prejudice so that plaintiffs may (if the pertinent facts warrant) bring new actions that do not include allegations of fraud 'in connection with the purchase or sale of a . . . security.'" *Id.* Petitioner seeks review only of the portion of the Second Circuit's Opinion holding that Respondent may avoid preemption by re-pleading his Complaint to exclude from the putative class, persons who purchased their securities holdings based on misrepresentations or omissions made by Merrill Lynch. Petition for a Writ of Certiorari at 10 n.4. Thus, the Second Circuit's holding that Dabit's claims for lost commissions are not pre-empted by SLUSA is not implicated by the Petition for a Writ of Certiorari.

In reaching its decision, the Court first determined that the judicial interpretation of "in connection with" the purchase or sale of a security under §10(b) and Rule 10b-5 applies in construing SLUSA. *Id.* at 35-36; Pet. App. at

19a-20a. The Court noted, however, that "the 'in connection with' phrase, while broad, is of course not unlimited." *Id.* at 37; Pet. App. at 23a.

> "[T]he incidental involvement of securities do[es] not implicate the anti-fraud provisions of the federal securities laws." The fraud must be integral to the purchase and sale of the securities in question. *Zandford*, the Supreme Court's most recent elaboration of the "in connection with" requirement, cautions that the phrase must not "be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of §10(b)."

Id. (citations omitted) (quoting *SEC v. Zandford*, 535 U.S. 813, 820, 122 S.Ct. 1899, 153 L.Ed.2d 1 (2002)).

Next, the Court identified a second limitation on the question of whether a given fraud arises "in connection with the purchase or sale" of a security so as to give rise to a private action for damages under Rule 10b-5, i.e., the procedural limitation prescribed by the purchaser-seller rule in *Blue Chip Stamps*. *Dabit*, 395 F.3d at 37; Pet. App. at 23a.

The Court then concluded that the *Blue Chip Stamps* rule applied to the SLUSA analysis. *Dabit*, 395 F.3d at 39-44; Pet. App. at 26a-36a.

> Congress employed language with a settled judicial interpretation of which *Blue Chip* was a part and we see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish non-purchaser and non-seller state class action claims.
>
> . . .

> The limitation on standing to bring private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities. . . . That observation, however, has little persuasive force in this context, because SLUSA deals with precisely the category of actions subject to the purchaser/seller rule. Once it is agreed that Congress deliberately borrowed SLUSA's "in connection with" language from §10(b), the fact that the standing rule is analytically distinct from the underlying prohibition on fraud does not compel the conclusion that SLUSA preempts more than the purchaser/seller category of private damages claims over which the "in connection with" source language operates. Because *only* purchasers and sellers have a federal private damages remedy, it is far more natural to suppose that Congress meant to import the settled standing rule along with the "in connection with" phrase as a substantive standard. Nor are we moved by the observation that the standing rule is merely a judge-made gloss on the statute and the rule because private Rule 10b-5 damages actions are themselves a creature of judicial implication.

Id. at 39-40; Pet. App. at 28a (citations omitted). Moreover, the Court held, "[t]o the extent the legislative history casts any light on the question, it suggests that Congress intended to preempt only those state claims that had migrated from state to federal court in response to the PSLRA." *Id.* at 41; Pet. App. at 32a.

REASONS FOR DENYING THE PETITION

A. This Case is in an Interlocutory Posture

The Second Circuit affirmed in part, vacated in part and remanded this action to the district court. Petitioner seeks certiorari review of only that portion of the Second Circuit's opinion that reversed the district court's dismissal of Dabit's holding claims with prejudice and remanded with the directive that Dabit shall be allowed leave to amend to (if the pertinent facts warrant) allege "holding" claims that do not include allegations of fraud "in connection with the purchase or sale of a . . . security." Dabit's claims for lost clients and commissions are not challenged. Thus, regardless of the Supreme Court's disposition, this case is destined for further proceedings in the district court. Accordingly, this case is in an interlocutory posture.

The Supreme Court generally awaits final judgment in the lower courts before exercising its certiorari jurisdiction. *Virginia Military Institute v. United States*, 508 U.S. 946, 113 S.Ct. 2431, 2432, 124 L.Ed.2d 651 (1993).

> [C]ertiorari jurisdiction is "to be exercised sparingly, and only in cases of peculiar gravity and general importance, and in order to secure uniformity of decision. *** Thus, the lack of finality of the judgment below may 'of itself alone' furnish sufficient ground for denial of the application."

R. Stern, E. Gressman, S. Shapiro and K. Geller, *Supreme Court Practice*, §4.18 (8th Ed. 2002) (quoting *Hamilton Brown Shoe Co. v. Wolf Bros. & Co.*, 240 U.S. 251, 258, 36 S.Ct. 269, 60 L.Ed. 629 (1916)). "[B]ecause the Court of Appeals remanded the case, it is not yet ripe for review

by this Court." *Brotherhood of Locomotive Firemen and Enginemen v. Bangor and Aroostook Railroad Co.*, 389 U.S. 327, 328, 88 S.Ct. 437, 19 L.Ed.2d 560 (1967) ("The Court of Appeals ruled on various legal issues presented to it but remanded to the District Court to consider whether there had in fact been a contempt, and, also, if there was a contempt, whether it was 'of such magnitude as to warrant retention, in part or to any extent, of the coercive fine originally provided for in contemplation of an outright refusal to obey.' ").

Moreover, it is possible that upon remand Respondent may be unsuccessful in pleading holding claims that are beyond SLUSA's reach. In such case, the question raised by Petitioner would likely be moot and review by the Supreme Court would not be implicated. The Supreme Court decides questions "in the context of meaningful litigation. Its function in resolving conflicts among the Court of Appeals is judicial, not simply administrative or managerial." *The Monrosa v. Carbon Black Export, Inc.*, 359 U.S. 180, 184, 79 S.Ct. 710, 3 L.Ed.2d 723 (1959). Moreover, the question raised by Petitioner can be presented when certiorari is later sought from the final judgment should such become necessary. Stern, *Supreme Court Practice* §4.18 at 260; *Virginia Military Institute*, 508 U.S. at 2431, 113 S.Ct. at 2432.

For these reasons the case is not certworthy.

B. The Purported Conflict Between the Circuits is False

Petitioner contends that the Court's holding in *Dabit* directly conflicts with the Seventh Circuit's holding in *Kirscher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir.

2005), *rehearing and rehearing en banc denied* (7th Cir. 2005). *Kirscher* was a case involving shareholders of mutual funds. The plaintiffs alleged that the funds' misconduct in setting prices had left the funds vulnerable to exploitation by arbitrageurs. The proposed class was defined as all investors who held the funds' securities during the defined period and neither purchased nor sold shares during that period. *Id.* at 483. The Seventh Circuit found that the plaintiffs' claims were preempted by SLUSA.

In its opinion, the Seventh Circuit pronounced that the *Blue Chip Stamps* purchaser-seller rule did not apply to the SLUSA analysis. However, the Court's ultimate holding and disposition of the case did not rest on this pronouncement. Instead, the Court held that "[p]laintiffs' claims are connected to their own purchases of securities and thus are blocked by SLUSA, whose pre-emptive effect is not confined to knocking out state-law claims by investors who have *winning* federal claims. . . ." *Kirscher*, 403 F3d at 484. In reaching this conclusion, the Court observed, among other things, that if the "funds had stated bluntly in their prospectus' (or otherwise disclosed to investors) that daily valuation left no-load funds exposed to short-swing trading strategies, that revelation would have squelched" the litigation. *Id.* at 484. The Court then observed:

> These observations show that plaintiffs' claims depend on statements made or omitted in connection with *their own* purchases of the funds' securities. They could have brought them directly under Rule 10b-5 in federal court (to the extent that the purchases occurred within the period of limitations). Indeed, most of the approximately 200 suits filed against mutual funds in the last two years alleging that the

> home-exchange-valuation rule can be exploited by arbitragers have been filed in federal court under rule 10b-5.

Id. at 484.

The purported conflict between the Second Circuit and the Seventh Circuit identified by Petitioner is a false one. This is so because the Seventh Circuit's pronouncement that the *Blue Chip Stamps* rule is not applicable to the SLUSA preemption analysis is nothing more than *obiter dicta*.

Black's Law Dictionary (Revised Fourth Edition) describes *dicta* as, among other things:

> Statements and comments in an opinion concerning some rule of law or legal proposition not necessarily involved nor essential to determination of the case in hand are *obiter dicta*, and lack the force of an adjudication.

Black's Law Dictionary defines "obiter dicta" as a statement "made during the course of delivering a judicial opinion, but one that is unnecessary to the decision in the case and therefore not precedential (though it may be considered persuasive)." *Best Life Assurance Co. v. Commissioner of Internal Revenue*, 281 F.3d 828, 834 (9th Cir. 2002) (quoting *Black's Law Dictionary* 1100 (7th Ed. 1999)).

Although the Seventh Circuit disagreed with the Second Circuit's determination that the *Blue Chip Stamps* purchaser/seller rule was a limitation on the preemptive reach of SLUSA, its resolution of the case did not rest upon this determination. Rather, the Seventh Circuit rested its decision on its determination that the alleged fraud occurred in connection with the plaintiffs' "own

purchases of securities." *Kirscher*, 403 F.3d at 484. In fact, the Court specifically stated that the plaintiffs could have brought their claims pursuant to Rule 10b-5.[1] *Id.* In other words, under the facts alleged as the Seventh Circuit found them, the *Kirscher* plaintiffs had *Blue Chip* standing to pursue remedies for Rule 10b-5 violations.[2] Thus, the Seventh Circuit's pronouncement concerning the inapplicability of the *Blue Chip Stamps* purchaser-seller rule to the SLUSA analysis was not necessary to its determination that plaintiffs' claims were preempted by SLUSA – it was *dicta*.

Panels of the United States Courts of Appeals are not bound by earlier panels' *dicta*. *Swann v. Southern Health Partners, Inc.*, 388 F.3d 834, 837 (11th Cir. 2004) (citing *Tagle v. Regan*, 643 F.2d 1058, 1064 (5th Cir. 1981); *Great Lakes Dredge and Dock Co. v. Miller*, 957 F.2d 1575, 1578 (11th Cir. 1992), *cert. denied*, 506 U.S. 981 (1992)); *Neal v. Roche*, 349 F.3d 1246, 1250 (10th Cir. 2003); *United States v. Burroughs*, 5 F.3d 192, 194 (6th Cir. 1993). Because the Seventh Circuit's pronouncement in *Kirscher* was mere dicta, subsequent panels of the Seventh Circuit, or even the same panel that decided *Kirscher*, do(es) not have to and may choose not to follow it. *See id.* Thus, the conflict among the Circuits as articulated by the Petitioner is a false one. There "must be a real or 'intolerable' conflict on

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[1] Also, though not specifically mentioned by the Seventh Circuit, among the proposed "holders" in *Kirscher*, there were undoubtedly individuals who were reinvesting dividends during the proposed class period. Such investors were, therefore, purchasers under the federal securities laws. *See Deutschman v. Beneficial Corp.*, 761 F.Supp. 1080, 1087 (D.Del. 1991).

[2] As characterized by the Seventh Circuit, such claims would have also been found to be preempted by the Second Circuit.

the same matter of law, not merely an inconsistency in dicta or in the general principles utilized." Stern, *Supreme Court Practice* §4.3 at 225.

Moreover, the Seventh Circuit is the only Circuit to reject the application of the *Blue Chip Stamps* rule to the SLUSA analysis. The other Circuits that have addressed the issue are in agreement that the *Blue Chip Stamps* analysis does apply. *See Kirscher*, 403 F.3d at 483. The D.C., First, Third, Fourth, Fifth, Sixth, and Tenth Circuits have yet to address the issue. Any decision by the Supreme Court on the issue should await the views of at least some of these Circuits.

Finally, although some Circuits, including the Second, have held that SLUSA related remand orders are not appealable, the Seventh Circuit will review such decisions.[3] Perhaps the issue could reach the Supreme Court through an Opinion issued by a subsequent Seventh Circuit Panel that either chose to follow or disregard the *Kirscher* Court's dicta.

For these reasons too, this case is not certworthy.

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[3] Just because a given Circuit does not hear appeals of SLUSA related remand orders does not mean the issue could not reach such Circuit for determination. The issue could reach the Circuit through a dismissal based on SLUSA preemption. It could also reach the Circuit through an action that originated in federal court. *Dabit* is just such a case. Also, numerous Circuits have yet to address the appealability of SLUSA related remand orders. These Circuits may follow the lead of the Seventh Circuit and find such orders are appealable. Moreover, the Seventh Circuit's determination that it had jurisdiction to consider the appeal of the district court's remand order itself creates a conflict among the Circuits, although not with the Second Circuit's holding in *Dabit*. This creates the unusual situation that the Seventh Circuit may have in fact lacked jurisdiction to make the ruling that Petitioner relies on for the purported conflict in this case.

C. The Second Circuit's Interpretation of SLUSA is Correct and Consistent with the Purpose of the Statute

In deciding the scope of SLUSA preemption, the Second Circuit started with the "assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." *Dabit v. Merrill Lynch*, 395 F.3d at 41; Pet. App. at 30a-31a (quoting *City of Milwaukee v. Illinois*, 451 U.S. 304, 316, 101 S.Ct. 1784, 68 L.Ed.2d 114 (1981)). A federal statute will not be regarded as completely preemptive of state law absent some express statement or other clear manifestation from Congress. *Id.* (citing *Marcus v. AT&T Corp.*, 138 F.3d 46, 54 (2nd Cir. 1998) (citing *Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 65-68, 107 S.Ct. 1542, 95 L.Ed.2d 55 (1987))).

After determining that SLUSA does not anywhere define the phrase "in connection with the purchase or sale of a covered security," *Dabit v. Merrill Lynch*, 395 F.3d at 34; Pet. App. at 17a, the Court reviewed and discussed extensively the legislative history of SLUSA. The Court noted:

> "SLUSA comports with Congress's stated goal in enacting SLUSA of closing the 'federal flight loophole' by stemming the migration of claims from federal to state court. *See* SLUSA §2, 112 Stat. at 3227 (finding that "a number of securities class action lawsuits have shifted from Federal to State courts" and reciting that SLUSA aims to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]"). *Accord Lander* 251 F.3d at 107-08. If the "in connection with" phrase is read to reach the same

> conduct under SLUSA as it does under §10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA.

Id.[4] at 36; Pet. App. at 21a.

The Second Circuit's conclusions are supported by the comments of Senator Christopher J. Dodd, one of the two principal sponsors of SLUSA. As the Second Circuit pointed out, Senator Dodd stated that SLUSA "if enacted, will allow Congress to address this state litigation problem . . . preempting only those class actions that have recently migrated to state court, while leaving traditional state court actions and procedures solidly in place." *Id.* at 42; Pet. App. at 32a-33a. Senator Dodd further explained that "[t]his legislation has been carefully crafted only to affect those types of class actions that are appropriately heard on the federal level." 143 Cong. Record §10475-01, 1997 WL 614735. Pure "holding" claims simply do not meet this criteria. Pure "holding" claims are not actionable under rule 10b-5[5] and have never been subject to the requirements of the PSLRA. *See Blue Chips Stamps*, 421 U.S. 723.

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[4] The Second Circuit in *Lander v. Hartford Life & Annuity Insurance Co.*, 251 F.3d 101, 110 (2nd Cir. 2001), previously observed that "both the statutory findings and the accompanying conference report make it clear that SLUSA targeted class action litigation intended to be reached by the PSLRA, which evaded the procedural requirements of the PSLRA by migrating to state court."

[5] The *Blue Chip Stamps* Court noted that the disadvantage imposed on Plaintiffs by not being able to seek remedies for such claims under Rule 10b-5 is "alleviated to the extent that remedies are available to purchasers and nonsellers under state law." *Id.* at 738 n.9, 95 S.Ct. 1917.

The Seventh Circuit's reasoning and the SEC's and Petitioner's argument that Merrill Lynch's conduct could give rise to civil enforcement actions by the SEC or criminal prosecutions and therefore is subject to SLUSA preemption misses the mark. SLUSA was enacted to address concerns that private litigants asserting private rights of actions for damages were skirting the heightened pleading standards imposed on Rule 10b-5 plaintiffs by the PSLRA. *Dabit v. Merrill Lynch*, 395 F.3d at 39-40; Pet. App. at 28a.

Petitioner's, the SEC's and Amicus' argument that the other elements necessary for maintenance of a successful action for damages under Rule 10b-5 should not limit the Court's construction of "in connection with" under SLUSA and therefore, it is improper to apply the standing rule applicable to such claims as a limit on SLUSA preemption also misses the mark. As stated by the Second Circuit:

> We need not and do not reach the question, but see no contradiction in concluding that Congress could have intended to pre-empt state law securities fraud actions that if brought under federal law would fail for proof of loss causation or lack of timely filing, but did not intend to pre-empt a category of actions that, because of the nature of the injury alleged, could never have constituted a potential federal action.

Id. at 43; Pet. App. at 35a.

Equally unavailing is the Seventh Circuit's reasoning and Petitioner's argument that because SLUSA aimed to shore up the PLSRA's remedial goal of curbing meritless strike suits, it would be anomalous for Congress to intend to carry over the purchaser-seller rule as a limiting construction of the "in connection with" language, because the

effect would be to permit the very category of claims that the Supreme Court identified in *Blue Chip* as posing a particularly high risk of vexatious litigation. As the Second Circuit aptly noted:

> The question in interpreting ambiguous statutory language . . . is not what Congress might sensibly want to do, but what Congress did.

Id. at 40; Pet. App. at 29a.

In short, the legislative history of SLUSA, and the statute itself "suggest that Congress intended to preempt only those state claims that had migrated from federal court in response to the PSLRA," *see id.* at 41-42 and n.10, and the Second Circuit's holding was correct.[6]

> Congress certainly understood that Rule 10b-5's "in connection with the purchase or sale" language had been interpreted for nearly a half century as limiting standing to transacting plaintiffs. Nonetheless, Congress replicated the same language in SLUSA, with no mention of any intent to extend its meaning to encompass claims brought by non-transacting individuals. This backdrop provides strong evidence that Congress did not intend to preempt holding claims.
>
> If the survival of holding claims serves to undermine the Reform Act in an intolerable way,

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[6] In reaching its decision, the Court gave only limited deference to the SEC's opinions concerning the application of SLUSA because "[t]he preemptive provisions of SLUSA, . . . unlike the parallel provisions of §10(b), do not create powers in the SEC or vest the SEC with any rule making, adjucative or other enforcement or interpretative responsibility. *Dabit v. Merrill Lynch*, 395 F.3d at 34 n.6; Pet. App. at 17a-18a.

> Congress can respond, much as it did with the passage of SLUSA itself and correct the oversight.

A. Rose, *Life After SLUSA; What Is the Fate of Holding Claims?*, 69 Def. Couns. J. 455, 460 (2002); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598 (8th Cir. 2002).

For these reasons, too, the case is not certworthy.

CONCLUSION

For the reasons set forth herein, the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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No. 04-1371

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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15 U.S.C. 78j(b)). .....*passim*

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Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) 6

Respondent does not dispute that the question presented in the petition for certiorari involves an important issue of federal statutory law. Instead, he contends that certiorari should not be granted because: (i) there is no circuit conflict insofar as the Seventh Circuit's contrary holding is mere *dictum*; (ii) review is sought in an interlocutory posture; and (iii) the Second Circuit's holding below that state law claims brought by "holders" of securities are not preempted by the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA") is consistent with the legislative purpose of that federal act.

None of the respondent's contentions refutes or undermines the arguments why certiorari is warranted. First, there is a direct and deep circuit conflict on the question presented in this petition. Respondent's assertion that the Seventh Circuit's contrary holding is mere *dictum* is incorrect. Judge Easterbrook explicitly stated that because of the nature of the allegations before it, the court had to answer the central legal question concerning the scope of SLUSA's preemptive effect (which is identical to the question presented in this case) and could not "postpone its resolution." *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 483 (7th Cir.) (Easterbrook, J.), *rehearing denied*, No. 04-1495, 2005 U.S. App. LEXIS 7914 (7th Cir. May 2, 2005). (*See* pp. 2-5, *infra*.)

Second, interlocutory review is the only effective way to address meaningfully the issue presented in this case and to further the purpose of the statute at issue here. This Court on numerous occasions has granted certiorari in securities cases such as this, where the court of appeals had reversed summary judgment or dismissal of the complaint and remanded for further proceedings. (*See* pp. 5-8, *infra*.)

Third, the decision below is inconsistent with SLUSA's plain language, which contains no "purchaser-seller" limit to the scope of preempted claims it sets forth. If the decision below is allowed to stand, SLUSA will necessarily fail in its purpose to establish uniform national standards for securities litigation. "Holding" claims have been disallowed in federal private securities actions by the judicially crafted purchaser-seller standing requirement precisely because federal courts

have determined that the potential for private abuse of such claims is disproportionately great. Yet to allow such claims to be brought under state law – in circumstances where national and international companies such as petitioner will be exposed to class action litigation under multiple state procedural and substantive standards, complicated enormously by difficult choice of law questions regarding the application of different states' laws to different members of the nationwide classes – directly contravenes the language and purpose of SLUSA to establish uniformity and to promote efficiency in the national securities markets. (*See* pp. 8-10, *infra*.)

1. The Rule Announced by the Seventh Circuit in *Kircher* Is Not Mere *Dictum*

Respondent contends that "under the facts alleged as the Seventh Circuit found them, the *Kirscher* [*sic*] plaintiffs had *Blue Chip* standing to pursue remedies for Rule 10b-5 violations." (Respondent's Brief in Opposition, at 10 (hereafter "Resp. Br.").) Accordingly, he asserts that the Seventh Circuit's rule – that state law claims which are preempted under SLUSA include pure "holding" claims, and are not limited to those which satisfy the purchaser-seller requirement under *Blue Chip Stamps* for viable private federal securities claims[1] – is mere *dictum*.

But the putative class as defined in the complaint considered in *Kircher* did *not* have *Blue Chip* standing to assert federal securities claims under section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)). The Seventh Circuit expressly stated that "[the purchaser-seller rule of] *Blue Chip Stamps* would prevent such a private action from proceeding under Rule 10b-5," noting that one of the complaints at issue "define[d] the class as all investors who held the fund's securities during a defined period *and* neither purchased nor sold shares during that period." *Kircher*, 403 F.3d at 483. As respondent himself incongruously recognizes, "[t]he proposed class [in *Kircher*] was defined as all investors who held the fund's securities during the defined period and *neither*

[1] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

purchased nor sold shares during that period." (Resp. Br. at 8 (citing *Kircher*, 403 F.3d at 483).)

Because the class at issue in *Kircher* did not include purchasers or sellers of the securities during the defined period, it was necessary for the Seventh Circuit to decide the central legal issue, also presented in this petition: whether under SLUSA "holding" claims that cannot be brought under the federal securities laws for failure to satisfy the purchaser-seller standing requirement of *Blue Chip Stamps* may nevertheless be brought under state law.

In considering this issue, Judge Easterbrook described the varying views of other courts of appeals on the issue of SLUSA preemption of state law holding claims:

> An equation between SLUSA's coverage and the scope of private damages actions under Rule 10b-5 has the support of the second circuit (*Dabit*), the eighth circuit (*Green*), and the eleventh circuit (*Riley*). The ninth circuit (*Falkowski*), by contrast, has written that coverage of SLUSA tracks the coverage of § 10(b) and Rule 10b-5 when enforced by *public* plaintiffs (the SEC or a criminal prosecutor). The third circuit (*Rowinski*) has reserved decision on this issue. The Securities and Exchange Commission filed a brief in *Dabit* as amicus curiae supporting the view that SLUSA tracks the full scope of § 10(b) and Rule 10b-5, not just their enforcement in private actions.

Kircher, 403 F.3d at 483. He then went on to consider, and specifically reject, that resolution of this issue on which the courts of appeals had grappled could be avoided in deciding the case: "The way the *Spurgeon* class has been defined prevents us from following the third circuit's path: **we must answer the question rather than postpone its resolution**." *Id.* (emphasis added).

Turning to the merits of the question, the Seventh Circuit reviewed the plain language of SLUSA as well as the policies underlying both SLUSA and the purchaser-seller rule. It concluded, in direct conflict with the decision below: "We hold that SLUSA is as broad as § 10(b) itself and that limitations on private rights of action to enforce § 10(b) and

Rule 10b-5" do not apply to SLUSA's "in connection with the purchase or sale" language and therefore the exclusion of purchasers or sellers from a plaintiff's putative class does not avoid preemption. *Id.* at 484.[2]

In the course of rendering this holding, Judge Easterbrook observed in passing that the *Kircher* plaintiffs' state law class action claims and the putative class period *could* have been redefined so as to constitute federal securities law claims based on misrepresentations or omissions in connection with their securities purchases. He observed that at least some part of the *Kircher* class plaintiffs *would* have had *Blue Chip* standing under the federal securities laws *had they defined their putative class differently and pled their claims differently, i.e.*, had they not attempted to define a class without purchasers or sellers. *See Kircher*, 403 F.3d at 484. But they did not so plead and so, as Judge Easterbrook explicitly stated, resolution of the issue presented in this petition was necessary to the Seventh Circuit's disposition of the class allegations in *Kircher*. *See id.* at 483.[3]

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[2] Between the time of the issuance of the Seventh Circuit's mandate in *Kircher* and the dismissal by the district court, several of the plaintiffs sought to amend their complaints to withstand preemption. These efforts were denied. *See, e.g., Spurgeon v. Pacific Life Ins. Co.*, No. 04-cv-0355-MJR (slip op.) (S.D. Ill. May 27, 2005).

[3] The Seventh Circuit's observation concerning plaintiffs' ability to have pled their claims differently simply illustrated Judge Easterbrook's conclusion that plaintiffs in that case had manipulated their claims to avoid federal jurisdiction:

> Our plaintiffs' effort to define non-purchaser-non-seller classes is designed to evade PSLRA in order to litigate a securities class action in state court in the hope that a local judge or jury may produce an idiosyncratic award. It is the very sort of maneuver that SLUSA is designed to prevent.

Id. at 484. The same can be said of respondent's allegations in this case. Respondent has defined an arbitrary "holding" class period beginning on December 1, 1999. In the related federal securities fraud cases based on the same alleged conduct and involving many of the same securities, the putative class periods often begin earlier than December 1, 1999. For example, the putative class period for the section 10(b) claim relating to purchases of Internet Capital – securities Dabit asserts he was injured from holding – begins four months before Dabit's "holding" period, *i.e.*, on August 5, 1999.

In their petition seeking *en banc* rehearing, the *Kircher* plaintiffs affirmed unequivocally that the question presented herein was in fact decided by the Seventh Circuit, in deep and direct conflict with other courts of appeals:

> These eight consolidated cases present questions of exceptional importance (and of first impression) because the panel's decision conflicts with the decisions of the Second, Eighth, Ninth and Eleventh Circuits. Three of those circuits have held that the Securities Litigation Uniform Standards Act (SLUSA) does not preempt state law claims in connection with the retention of securities but rather, as the statutory language expressly provides, preempts only class action securities fraud claims "in connection with the purchase or sale of a covered security." As the Second Circuit noted, "this holding aligns us with every circuit court that has considered the question thus far." The *Kircher* panel is the only court to rule otherwise.

(*Kircher* Appellees' Petition for Rehearing En Banc at 1 (citations omitted) (quoting *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 43 (2d Cir. 2005); citing *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002); *Green v. Ameritrade, Inc.*, 279 F.3d 590 (8th Cir. 2002)).)[4] Respondent's assertion that the Seventh Circuit's ruling was mere *dictum* is thus incorrect and the deep and direct conflict between the courts of appeals on the important issue presented in this petition cannot be refuted.

2. The Question Presented Is Ripe for Review by this Court and May Be Effectively Unreviewable at a Later Stage

Respondent cites the interlocutory posture of this case as a reason why the Court should not review the issue presented. A requirement of a final judgment from the district court and a second appeal, however, would almost certainly *prevent* any effective review by this Court in light of the nature of the case.

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[4] The *Kircher* Appellees' petition for rehearing was denied on May 2, 2005. *Kircher v. Putnam Funds Trust*, No. 04-1495, 2005 U.S. App. LEXIS 7914 (7th Cir. May 2, 2005).

On numerous occasions in similar circumstances, this Court has granted certiorari in securities cases such as this, where the court of appeals had reversed and remanded for further proceedings following dismissal of the complaint or a grant of summary judgment. The issue in this case now presents compelling reasons for interlocutory review.

Were it necessary to resolve all of the issues in the district court and await final judgment in respondent's case, there would likely not be any opportunity for meaningful review of the question presented. As this Court described at length in *Blue Chip Stamps*, the *in terrorem* effect of securities class action litigation often forces settlements out of proportion to the merits of the case, both because of the burden of the broad discovery sought in such cases, and because of the risk, however small, of a potentially bankrupting judgment. *See, e.g.*, 421 U.S. at 740-41 ("[E]ven a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long has he may prevent the suit from being resolved against him by dismissal or summary judgment."). A case such as respondent's here – alleging claims involving 48 different securities and with the proof of such claims depending "almost entirely on oral testimony," *id.* at 743 – is just the sort of case the *Blue Chip Stamps* Court found particularly unlikely to go to final judgment. *See id.* at 740-43.[5]

In explicit recognition of the disproportionate costs and dangers to defendants of allowing meritorious as well as unmeritorious class action suits to proceed to discovery, the statutory framework of SLUSA provides – and was expressly intended to provide – the means for the immediate removal

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[5] This same concern has been cited by courts of appeals when granting discretionary interlocutory review. The Second, Third and Seventh Circuits, for example, have explained that due to the "'hydraulic pressure on defendants to settle, avoiding the risk, however small, of potentially ruinous liability'" once a class has been certified "very few securities class actions are litigated to conclusion." *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) (quoting *Newton v. Merrill Lynch*, 259 F.3d 154, 164 (3d Cir. 2001) and *West v. Prudential Sec., Inc.*, 282 F.3d 935, 937 (7th Cir. 2002) (Easterbrook, J.) (citations omitted)); *see also* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

and dismissal of state law claims alleging misrepresentations or omissions or deceptive devices or contrivances in connection with the purchase or sale of securities. If this Court were to deny review based simply upon the interlocutory posture of this case, thereby requiring the fulsome litigation of respondent's claims to their conclusion prior to full legal review of their sufficiency, SLUSA's express purpose would be frustrated.

Indeed, in light of the unlikelihood of a final judgment on the merits in the securities context, this Court regularly reviews federal securities law cases in an interlocutory posture. Most recently, the Court granted review in *Dura Pharmaceuticals, Inc. v. Broudo*, 124 S. Ct. 2904 (2004), despite the fact that the action was in an interlocutory posture and there would be further proceedings in the district court regardless of how this Court ruled. In *Dura*, the loss causation issue on which the petitioner sought and successfully obtained review related to only one of the alleged misstatements in the case, *see Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1629-30 (2005), although in the opinion below, the Ninth Circuit had granted plaintiffs leave to amend to address various other pleading defects. *See Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 940-41 (9th Cir. 2003), *rev'd on other grounds*, 125 S. Ct. 1627 (2005).

Similarly, this Court has granted interlocutory review in several other securities law cases, notably in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (aiding and abetting liability); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (statute of limitations); *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (materiality and reliance); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (breach of fiduciary duty); and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter).

Interlocutory review is especially warranted in this case, because the courts of appeals will be unable to resolve the conflict absent a decision by this Court. State law claims brought within those circuits which have held that such claims are not preempted by SLUSA will be subject to remand orders to state court. But three of those courts of appeals - including the Second Circuit - have held that they have no appellate

jurisdiction to review remand orders pursuant to SLUSA. (*See* Pet. at 12.) Accordingly, these circuits are unlikely to have an opportunity to revisit or refine their holdings concerning SLUSA preemption. Because several courts of appeals, including the Second Circuit below, already have decided the question presented in a manner that conflicts with the Seventh Circuit's and the SEC's views, the issue is sharply presented for review now.

3. The Second Circuit's Interpretation of SLUSA's "In Connection With" Requirement in the Decision Below Is Contrary To SLUSA's Language and Intent

The decision below directly contravenes the plain language of SLUSA and frustrates its purpose. Congress enacted SLUSA to establish uniform national standards of liability for conduct alleged to affect national securities markets and to eliminate fragmentary investor remedies. (*See* Pet. at 11.) The broad, preemptive reach of SLUSA reflects Congress's judgment that because of their great potential for abuse, private securities class actions (as opposed to individual actions or public enforcement actions) must proceed in federal court under "federal securities law or not at all." *Kircher*, 403 F.3d at 484; *see Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 123 (2d Cir. 2003).

SLUSA preempts more than simply those claims that could have been brought as private federal actions under section 10(b). (*Cf.* Resp. Br. at 12-15; Pet. App. at 21a.) Respondent does *not* refute petitioner's "plain statutory language" argument that the *Blue Chip Stamps* purchaser-seller standing requirement is not a construction of the "in connection with" language of section 10(b). Rather, it is a limitation on standing imposed by the Court on a subset of enforcement mechanisms under section 10(b), namely, private rights of action for damages under section 10(b). (*See* Pet. at 13-15.) As Judge Easterbrook noted, section 10(b) still applies to prohibit conduct in actions where the plaintiff is not a purchaser or seller, namely, in actions brought by public enforcement authorities. *See Kircher*, 403 F.3d at 483 (citing *SEC v. Zandford*, 535 U.S. 813, 821-22 (2002); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971)).

Because the purchaser-seller requirement is a judicially crafted *standing* limit only on private federal securities actions rather than a limit on the full statutory scope of section 10(b), it cannot limit the preemptive scope or effect of SLUSA, which uses the identical "in connection with" statutory language as does section 10(b). Indeed, as Judge Easterbrook observed:

> By depicting their classes as containing entirely non-traders, plaintiffs do not take their claims outside § 10(b) and Rule 10b-5; instead they demonstrate only that the claims must be left to public enforcement. It would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all. *Blue Chip Stamps* combined with SLUSA may mean that claims of the sort plaintiffs want to pursue must be litigated as derivative actions or committed to public prosecutors, but this is not a good reason to undercut the statutory language.

Kircher, 403 F.3d at 484.

Rather than refute this plain statutory language argument, respondent relies entirely upon isolated excerpts from the legislative history of SLUSA to argue that Congress intended to import the judicially created purchaser-seller requirement of standing in the federal context into SLUSA's definition of preempted state law claims. Respondent's attempted resort to legislative history cannot, however, contradict a statute that on its face plainly contains no such limiting language. *See, e.g.*, *Spielman*, 332 F.3d at 124 ("[W]e cannot ignore Congress' clear intent that SLUSA completely preempt certain types of class action securities lawsuits.").

Finally, a rule of decision, like the Court's below, which judicially restricts the broad preemptive scope of SLUSA is not necessary to ensure that alleged wrongdoers will remain subject to vigorous statutory enforcement. As the facts of this

very case demonstrate, federal and state regulators remain able and willing to pursue effective enforcement actions on behalf of the public. Plaintiffs may also bring the same actions *individually* under state law theories, or as class actions under the federal securities laws. It is only state law private class actions - which Congress determined, as a matter of its legislative judgment, are disproportionately prone to abuse - that SLUSA preempts and requires to be brought under federal law and in a federal forum, or not brought at all.

As the SEC explains in its brief filed in *Dabit* (Pet. App. 72a-100a), "the phrase 'in connection with the purchase or sale' of securities, as used in SLUSA, has the same broad meaning as in Section 10(b) of the Exchange Act." (Pet. App. 80a.) "Adopting for SLUSA purposes a construction of the term that is more restrictive than the definition applied under Section 10(b) would mean that litigants could continue to bring some cases under state law rather than being forced to sue under Section 10(b) and its attendant constraints." (Pet. App. 81a.) The Second Circuit's decision below to the contrary not only contravenes the SEC's urged interpretation of SLUSA's language and purpose, but also conflicts with the reasoned opinion of the Seventh Circuit in *Kircher*.

This Court should grant the petition to review, in plenary fashion, the merits of the question presented in light of the direct split among the courts of appeals - a split which, both by its existence and in its substance, impedes Congress's consistently stated objective to ensure uniform national standards for securities litigation involving nationally traded securities. (*See* Pet. at 16-17.)

CONCLUSION

For all of the foregoing reasons and the reasons stated in the Petition, the petition for a writ of certiorari should be granted.

Dated: New York, New York
July 19, 2005

Respectfully submitted,

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No. 04-1371

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SUPPLEMENTAL BRIEF OF PETITIONER IN FURTHER SUPPORT OF THE PETITION FOR CERTIORARI

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

On April 11, 2005, Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") petitioned this Court for certiorari review in this matter, in light of the square conflict between the Second Circuit's decision below and the Seventh Circuit's decision in *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005) (Easterbrook, J.), *rehearing denied*, No. 04-1495, 2005 U.S. App. LEXIS 7914 (7th Cir. May 2, 2005). Pursuant to Rule 15(8) of the Rules of this Court, petitioner hereby files this supplemental brief to bring to the Court's attention two subsequent, recent developments relevant to its consideration of the Petition.

First, the individual class plaintiffs in *Kircher* have informed the Court that they intend to file a petition for certiorari seeking review of the Seventh Circuit's decision. *See Kircher v. Putnam Funds Trust*, No. 05A73. As a result of two extensions of time, the *Kircher* petition is now due September 29. In their applications for extensions of time, the *Kircher* petitioners cited the circuit split on the question presented as warranting review by this Court. *See* No. 05A73, Application for Second Extension of Time Within Which to File Petition for Certiorari to the United States Court of Appeals for the Seventh Circuit (Aug. 19, 2005), at 3; Application for Extension of Time Within Which to File Petition for Certiorari to the United States Court of Appeals for the Seventh Circuit (July 20, 2005), at 2.

Second, the Seventh Circuit very recently issued another decision in conflict with the decision below. It held, relying on *Kircher*, that putative class claims should have been dismissed as preempted by SLUSA where they asserted that allegedly false and misleading investment recommendations induced putative class members to "continue holding" any of several "Internet or Telecom Stocks." *Disher v. Citigroup*

Global Markets Inc., No. 04-3073, 2005 U.S. App. LEXIS 17334, at *2-4, *14-17 (7th Cir. Aug. 17, 2005). The *Disher* court noted that while the Second Circuit's decision below supported plaintiffs' position that SLUSA incorporated a purchaser-seller requirement, the Seventh Circuit had "concluded that SLUSA's 'in connection with the purchase or sale of a covered security' requirement does not incorporate the *Blue Chip Stamps* standing rule." *Id.* at *15 (citing *Kircher*, 403 F.3d at 483-84). The *Disher* court also noted that "[t]he Supreme Court has not yet had occasion to consider this phrase ['in connection with the purchase or sale of a covered security'] in the context of SLUSA." *Id.* at *13. The *Disher* court also confirmed, contrary to the argument in respondent's opposition, that the SLUSA holding of the Seventh Circuit in *Kircher* was not mere dictum but rather was essential to the court of appeals' disposition of the complaints at issue in that case: "In *Kircher*[], one of the plaintiffs' classes was defined as all investors who held the defendant mutual fund's securities during a defined period and did not purchase or sell shares during that period." *Disher*, 2005 U.S. App. LEXIS 17334, at *15 (citing *Kircher*, 403 F.3d at 483). *Disher*, therefore, further supports Merrill Lynch's position that review by this Court is warranted because of the square conflict among the circuits on an important issue of federal statutory law. (*See* Pet. at 11-21.)

As noted, plaintiffs in *Kircher* will be filing their petition by September 29, 2005, after which a response may be filed or requested. In light of the importance of an expeditious resolution of the question presented to the federal securities markets, as well as the time which already has elapsed since the decision below was rendered in January 2005 and the Petition filed in April 2005, petitioner respectfully urges that the Petition be granted or that the views of the Solicitor General be requested at this time.

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No. 04-1371

IN THE

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MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Petitioner,

v.

SHADI DABIT, on behalf of himself and
all others similarly situated,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

MOTION FOR LEAVE TO FILE A BRIEF AS *AMICI CURIAE* AND BRIEF FOR THE SECURITIES INDUSTRY ASSOCIATION AND THE BOND MARKET ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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IN THE

Supreme Court of the United States

No. 04-1371

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
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SHADI DABIT, on behalf of himself and
all others similarly situated,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

MOTION OF THE SECURITIES INDUSTRY ASSOCIATION AND THE BOND MARKET ASSOCIATION FOR LEAVE TO FILE A BRIEF AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

The Securities Industry Association ("SIA") and the Bond Market Association ("TBMA") hereby request, pursuant to Rule 37.2 of the Rules of this Court, leave to file the accompanying brief as *amici curiae* in support of Petitioners. SIA and TBMA obtained the consent of the Petitioners.

SIA and TBMA offer this brief because the issue to be decided affects the interests of the SIA and TBMA and their members. The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and

foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues.

TBMA was created in 1976 and represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. TBMA members include all primary dealers in U.S. government securities and all major dealers in federal agency securities, mortgage-backed and asset-backed securities, corporate bonds, money market instruments, and funding instruments such as repurchase and securities lending agreements. TBMA has worked with Congress, the SEC, the Federal Reserve Board, the Federal Reserve Bank of New York, state regulators and self-regulatory organizations to foster effective, efficient regulation of the markets.

The SIA and/or TBMA have previously filed *amici* briefs with the Court in cases affecting civil liability and the federal securities laws. See, *e.g.*, *Dura Pharms., Inc.* v. *Broudo*, 125 S. Ct. 1627 (2005); *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002); *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350 (1991); *Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989); *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220 (1987).

The question presented by this case is whether the preemption provision of the Securities Litigation Uniform Standards Act ("SLUSA") applies to state-law class actions by securities holders who claim that they refrained from selling securities in reliance on a misrepresentation. This issue is critically important to the SIA and TBMA because such suits undermine the efforts of Congress to curb

vexatious litigation and enact uniform national standards for securities class actions. The SIA and TBMA therefore have a vital interest in the issue presented in this case and the SIA and TBMA's views can assist the Court in deciding whether certiorari should be granted.

For the foregoing reasons, SIA and TBMA's Motion for Leave to File a Brief as *Amici Curiae* in support of Petitioners should be granted.

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May 16, 2005

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The Bond Market Association, *at* http://www.bondmarkets.com (last visited May 13, 2005)	2

INTEREST OF THE *AMICI CURIAE*[1]

The Securities Industry Association ("SIA"), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers' Association, represents the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. (More information about SIA is available at www.sia.com.)

The Bond Market Association ("TBMA") represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. TBMA's members transact business in a wide variety of public and private fixed-income securities. Its membership comprises a diverse mix of securities firms and banks, including large, multi-product firms and companies with special market niches. It includes all primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in federal agency securities, mortgage-backed and asset-backed securities, corporate bonds, money market instruments, and funding instruments such as repurchase and securities lending agreements. From its inception in 1976, TBMA has worked with its member firms, Congress, the SEC, the Federal Reserve Board and the Federal Reserve

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[1] Pursuant to this Court's Rule 37.6, *amici* SIA and TBMA state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici* and their members made a monetary contribution to the preparation or submission of the brief.

Bank of New York, state regulators, and self-regulatory organizations to foster effective, efficient regulation; to enhance the liquidity and efficiency of the fixed income markets; to encourage sound credit and business practices for participants in such markets; and to promote the highest levels of professional standards and conduct in such markets. (More information about TBMA is available at www.bondmarkets.com.)

The issue raised by this case is whether holders of securities, who "refrained from selling" securities in reliance upon an alleged misrepresentation, Pet. App. 4a-5a, can bring state-law class actions that avoid the preemption provision of the Securities Litigation Uniform Standards Act ("SLUSA"). This issue is one of great import to the securities industry and investors in this era of proliferating securities litigation. It is critically important to the SIA and TBMA that the effort of Congress to curb vexatious litigation in state law securities fraud suits by enacting the uniform national requirements of the Private Securities Litigation Reform Act ("PSLRA"), not fall prey to creative plaintiffs who attempt to plead around SLUSA preemption and the strict federal securities standards. *Amici* therefore have a vital interest in the issue presented in this case, and their views can assist the Court in resolving that issue.

INTRODUCTION

Compelling reasons warrant granting certiorari. The petition presents an acknowledged conflict in the circuit courts of appeal. The conflict concerns an important and recurring issue – whether the preemption provision of SLUSA applies to securities fraud class actions on behalf of holders of securities that allege they refrained from selling securities in reliance on an alleged misrepresentation. This conflict threatens both the national uniformity that SLUSA and the PSLRA sought to create and the efficient functioning of the

securities markets. Only a decision by this Court will resolve this recurring and important issue.

REASONS FOR GRANTING THE PETITION

I. THIS CASE PRESENTS AN ACKNOWLEDGED CONFLICT THAT WILL NOT BE RESOLVED WITHOUT INTERVENTION BY THIS COURT.

15 U.S.C. § 78bb(f)(1) preempts any class action based upon state law concerning a material misrepresentation or omission "in connection with the purchase or sale of a covered security." As the Seventh Circuit has acknowledged, there is a plain and undeniable conflict among the circuits concerning whether this provision preempts a class action brought by persons who already held the affected security before the misrepresentation or omission was made. The Seventh Circuit has held that such "holder" class actions are preempted. *Kircher* v. *Putnam Funds Trust*, 403 F.3d 478, 483-84 (7th Cir. 2005), *rehearing denied* (May 2, 2005). This is also the official position of the SEC. Pet. App. 91a-94a. The Second Circuit (in the decision from which a writ of certiorari is sought), Eighth Circuit, and Eleventh Circuit have held that "holder" claims are not preempted. *Dabit* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 43 (2d Cir. 2005); *Riley* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.2d 1334, 1342-43 (11th Cir. 2002); *Green* v. *Ameritrade, Inc.*, 279 F.3d 590, 596-99 (8th Cir. 2002).

An illustration will demonstrate the vastly different outcomes under the conflicting approaches. Suppose H buys stock at a price of $40 per share in defendant D *before* any alleged fraud. As time passes, the stock price climbs to $50. D allegedly suffers a business setback that it conceals for a period of time. *After* the alleged concealment begins, P purchases D's stock at $50 per share. Later, when the setback is subsequently disclosed, D's stock price drops to $30. H has remained a holder of D's stock throughout. H brings a class action based on state law alleging that the concealment

caused the holder class to refrain from selling at the $50 price.[2]

Separately, P brings a federal § 10(b) class action alleging that the concealment caused those who purchased after the concealment to suffer a loss from the post-purchase decline caused by the disclosure of the setbacks. In all federal circuits, the purchaser class action may proceed.

The circuit conflict concerns the holder class action. In the Seventh Circuit, the holder class action is preempted, and immediately dismissed. In contrast, in the Second, Eighth, and Eleventh Circuits, the holder case proceeds. Indeed, H's state law class action probably sues for both fraud and negligence, and for both compensatory and punitive damages, "in the hope that a local judge or jury may produce an idiosyncratic award." *Kircher*, 403 F.3d at 484.

It is important that this Court resolve the SLUSA preemption conflict now. In conjunction with the broad stock market declines between early 2000 and March 2003, there has been a proliferation of securities litigation. See, *e.g.*, Cornerstone Research, *Securities Class Action Case Filings – 2004: A Year in Review* 2, 16 (2005), *available at* http://securities.stanford.edu/clearinghouse_research/2004_YIR/2004010305.pdf. This includes numerous holder cases. See Pet. at 17 n.5 (collecting 24 reported federal decisions from 2000 to 2005 in holder cases). The Court should resolve this conflict now before additional judicial resources are wasted on this existing pipeline of preempted cases.

Most important, a prompt resolution from this Court is essential to meeting SLUSA's and the PSLRA's goals of national uniformity in securities litigation and an end to abusive securities cases. See Pet. at 3-4, 11, 16 (discussing

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[2] As we demonstrate *infra* at 10-11, the premise that a class of holders could have sold at the $50 price if the truth was disclosed earlier is economic nonsense.

legislative history). As this Court recognized in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), faced with potential securities class actions from all securities holders – not just purchasers and sellers – potential securities issuers and securities firms may conclude that "'[t]he hazards of a business conducted on these terms are [too] extreme.'" *Id.* at 748 (quoting *Ultramares Corp.* v. *Touche*, 174 N.E. 441, 444 (N.Y. 1931) (Cardozo, C.J.)). At a minimum, this Court has reaffirmed that it is bad policy to permit the "'*in terrorem*'" effect produced by meritless but large class actions that proceed past the pleading stages to discovery. *Dura Pharms., Inc.* v. *Broudo*, 125 S. Ct. 1627, 1634 (2005) (quoting *Blue Chip Stamps*, 421 U.S. at 741). The situation is particularly bad here. Many defendants face simultaneously a "holder" class action in state court and a "purchaser/seller" class action in federal court. This encourages not only a procedural morass of discovery conflicts and the like, but also inconsistent substantive rulings. This Court should put a stop to all of this now.

II. THE SECOND CIRCUIT'S DECISION IS IN CONFLICT WITH THE LANGUAGE OF SLUSA AND THIS COURT'S PRIOR INTERPRETATION OF *BLUE CHIP STAMPS*.

SLUSA preemption does *not* require a misrepresentation "in connection with the purchase or sale [by the class members'] of covered securit[ies.]" Rather, SLUSA preemption requires only a misrepresentation "in connection with the purchase or sale of *a* covered security." 15 U.S.C. § 78bb(f)(1) (emphasis added). Holder class actions rely in at least two ways on a misrepresentation "in connection with the purchase or sale of a covered security."

First, as this case illustrates, holder class actions necessarily allege a misrepresentation "in connection with the purchase or sale of a covered security" because they allege that a misrepresentation inflated the company's publicly-traded share price. See Pet. App. 6a (discussing respondents'

"allegations concerning Merrill Lynch's causing certain stocks to trade at 'artificially inflated' prices through the use of deceptive devices alleged to be the 'hallmarks of stock manipulation'"). Such alleged market price inflation requires that numerous purchases be made in reliance on the alleged material misrepresentation. Specifically, such alleged inflation occurs only when "the *market* price of shares *traded* on well-developed markets reflects all publicly available information and, hence, any material misrepresentations." *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 246 (1988) (emphases added).

Second, holder class actions necessarily allege an additional "connection" between the misrepresentation and "the purchase or sale of a covered security." Specifically, holder class actions allege that disclosure of the misrepresentation caused a decline in the company's stock price. Such an alleged decline exists only if a "lower price ... reflect[s]" that actual purchases and sales were made in reaction to the corrective disclosure of "the earlier misrepresentation." *Dura*, 125 S. Ct. at 1631-32.

The Second Circuit therefore properly did not say that the plain or literal language of SLUSA's preemption provision fell short of covering a holder class action. Rather, its decision rests entirely on the premise that when SLUSA was enacted in 1998, *Blue Chip Stamps* was the existing, authoritative interpretation of the exact same "language" appearing in § 10(b) of the 1934 Securities and Exchange Act, 15 U.S.C. § 78j(b). Pet. App. 27a, 29a. But this premise is flawed. Indeed, this Court held in 1997, before SLUSA's enactment, that *Blue Chip Stamps* did not rest on interpreting the "in connection with" language of § 10(b).

Specifically, in *United States* v. *O'Hagan*, 521 U.S. 642 (1997), the Court, quoting *Blue Chip Stamps*, 421 U.S. at 737, held: "We so confined the §10(b) private right of action because of 'policy considerations.'" 521 U.S. at 664. If Congress in 1998 was borrowing the existing judicial

interpretation of the "in connection with" language in § 10(b) when it enacted SLUSA, Congress surely would have been borrowing this Court's then-most recent decision, *O'Hagan*. See also *Holmes* v. *Securities Investor Prot. Corp.*, 503 U.S. 258, 284 (1992) (O'Connor, J., joined by White and Stevens, JJ., concurring in part and concurring in the judgment) ("The purchaser/seller standing limitation in Rule 10b-5 damages actions thus does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.'"); *Id.* at 289-90 (Scalia, J., concurring in the judgment) ("[T]he limitation we approved in *Blue Chip Stamps* was essentially a legislative judgment rather than an interpretive one."). *O'Hagan* authoritatively held that *Blue Chip Stamps* was *not* an interpretation of § 10(b)'s language. 521 U.S. at 664-65.

O'Hagan was right. The text of *Blue Chip Stamps* itself demonstrates that *Blue Chip Stamps* addressed not the interpretation of § 10(b)'s language, but rather the policy question of how to confine the judicially-created implied right of action for § 10(b) violations. The majority stated, "we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 737. The Court concluded,

> we are not dealing here with any private right created by the express language of §10(b) or Rule 10b-5. *No language* in either of those provisions *speaks at all* to the contours of a private cause of action for their violation. . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be *judicially delimited* one way or another unless and *until Congress addresses the question.*

Id. at 748-49 (emphases added).

Once it is recognized that *Blue Chip Stamps* is not based on the "in connection with" language, there is no basis on which

to constrict that language in SLUSA to less than its natural meaning.[3] Under that meaning, holder class actions that claim injury from the effects of a misrepresentation on a stock's market price, *supra*, at 5-6, are alleging a misrepresentation "in connection with the purchase or sale of *a* covered security." 15 U.S.C. § 78bb(f)(1) (emphasis added).

III. CONGRESS COULD NOT HAVE INTENDED THAT HOLDER CLASS ACTIONS WOULD HAVE MORE ROBUST REMEDIES THAN THOSE FOR PURCHASER AND SELLER CLASS ACTIONS.

Blue Chip Stamps plainly held that "holder" actions are abusive. As *Blue Chip Stamps* elucidated,

> a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury such as loss of a noncontractual opportunity to buy or sell, is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective hypothesis.

421 U.S. at 734-35.

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[3] Nothing in SLUSA's legislative history refers to holder class actions. The Second Circuit relied upon floor comments of Senator Dodd that "[t]his legislation has been carefully crafted only to affect those types of class actions that are appropriately heard on the federal level." 143 Cong. Rec. 10475, 10477 (daily ed. Oct. 7, 1997), *available at* 1997 WL 614735. This sentence is merely a conclusion based on the prior sentence's statement that seven kinds of actions will remain "in State court." *Id.* Holder class actions were omitted from this list of preserved actions. The ambiguous comments of a single Senator provide no basis to constrict SLUSA's natural meaning. *See, e.g.*, *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 383-85 & n.2 (1992) (holding that "natural meaning" of preemption provision of "'any . . . regulation . . . relating to rates, routes, or services'" reached state regulation of advertising even though the "legislative history contains no statements specifically addressed to state regulation of advertising").

It is completely illogical to think that in SLUSA Congress intended holder class action plaintiffs to have more robust remedies and litigation tools than are available to class action plaintiffs who actually purchased or sold securities in reliance upon a misstatement or omission. SLUSA prevents purchasers and sellers of a security from bringing class action claims based on state law even if they are pendent to their federal claims. See 15 U.S.C. § 78bb(f)(1) (preempting state law class actions claims "in any State or Federal court"); *Rieger* v. *Drabinsky* (*In re Livent, Inc. Noteholders Secs. Litig.*), 151 F. Supp. 2d 371, 385, 442-43 (S.D.N.Y. 2001) (dismissing pendent state claims for common law fraud, negligence and negligent misrepresentation by purchasers). Purchasers and sellers bringing a § 10(b) class action must prove scienter and loss causation, satisfy heightened pleading standards, and comply with an initial stay of discovery, and (if they prevail) their remedies exclude punitive damages. See *Boguslavsky* v. *Kaplan*, 159 F.3d 715, 721 (2d Cir. 1998) ("punitive damages are unavailable"); *Cyrak* v. *Lemon*, 919 F.2d 320, 326 (5th Cir. 1990) ("Punitive damages are not recoverable in a 10b-5 action."); *Pelletier* v. *Stuart-James Co.*, 863 F.2d 1550, 1557 (11th Cir. 1989) ("'Actual damages' has been interpreted to mean some form of economic loss and does not include punitive damages.").

If holders are permitted to bring state law class actions, the arsenal at their disposal would often include punitive damages, the exaction of burdensome, costly discovery prior to the motion to dismiss stage, and relaxed pleading standards. Holder class plaintiffs often would have multiple state-law theories of recovery at their disposal including fraud, negligent misrepresentation, and statutory remedies such as unfair and deceptive trade practices (often with treble damages). Many such state causes of action are also accorded a lengthier statute of limitations period. It is incomprehensible that Congress (or anyone) would have created a system where class actions for securities holders have more

robust potential remedies and litigation tools than class actions for purchasers and sellers.

Such an incomprehensible disparity would be even more inexplicable because every federal court to examine a holder claim before SLUSA concluded that, as a class, holders cannot be injured.[4] This is best explained in *Crocker* v. *FDIC*, 826 F. 2d. 347, 351 (5th Cir. 1987) (footnote omitted):

> The flaw in the [holders'] argument is that it assumes a market for the stock existed at an artificially high price. This inflated price, and hence the particular market for the stock, was maintained only because of the wrongdoing of the [defendants], who concealed material financial information from the shareholders and the public that would have demonstrated the failing condition of the [company]. It follows that, had this information been released, the stock price would have immediately and precipitously fallen especially if, as is implicit in the [holders'] theory, an entire class of shareholders had simultaneously dumped their stock on the market. Thus, there would have been no market for the stock at the artificially high price. Without such a market, the [holders'] envisioned "profit opportunity" evaporates into hardly more than an illusion.

Applying *Crocker*'s analysis to our earlier illustration, *supra*, at 3-4, it is clear what would have happened to the holder class if there had been no post-purchase misrepresentation concerning the business setback. If the business setback had been promptly disclosed, D's stock price would have fallen from $50 to $30 *sooner*. The misrepresentation thus postponed the holders' recognition of a loss but it did not cause any loss. For the holder class, the business setback caused any loss. *Accord Kagan* v. *Edison Bros. Stores, Inc.*, 907 F.2d 690, 691-92 (7th Cir. 1990); *Arent* v. *Distribution*

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[4] Such "holder" claims were brought in either diversity or RICO cases.

Scis., Inc., 975 F.2d 1370, 1374 (8th Cir. 1992) ("[A]ny injury to plaintiffs was not caused by [defendant's] failure to disclose. Plaintiffs were not harmed because they were unable to realize the true value of their stock – they were harmed because the true value of their stock was zero."); *Chanoff* v. *United States Surgical Corp.*, 857 F. Supp. 1011, 1018 (D. Conn. 1994), *aff'd*, 31 F.3d 66 (2d Cir. 1994) (*per curiam*); see also *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 329, 333-34 (2d Cir. 1971) (Friendly, J.) (holding that even if the purchaser-seller requirement was overruled, a holder could not prove injury, because "if the representation had not been made, the price of the stock would not have been inflated, and there would have been no gain to be realized by a sale"). It is simply senseless to read SLUSA's preemption provision as preserving more robust state law remedies for classes of uninjured securities holders than for classes of potentially injured securities purchasers and sellers.

IV. THIS COURT SHOULD GRANT CERTIORARI TO BLOCK THE SLIPPERY SLOPE INVITED BY THE SECOND CIRCUIT'S APPROACH.

As the SEC has noted, Pet. App. 96a & n.5, if failure to satisfy the purchaser/seller element for private § 10(b) actions may be used to defeat SLUSA preemption, plaintiffs will surely argue that so too does failure to satisfy 10(b)'s scienter requirement. See *Green* v. *Ameritrade, Inc.*, 120 F. Supp. 2d 795, 798-99 (D. Neb. 2000) (holding, in part, that a state law "claim [was] not preempted by SLUSA because no proof of scienter [was] required" by the state law claim), *aff'd on other grounds*, 279 F.3d 590 (8th Cir. 2002); *Burns* v. *Prudential Secs.*, 116 F. Supp. 2d 917, 924-26 (N.D. Ohio 2000) ("[P]laintiffs' allegations do not satisfy the scienter requirement for securities fraud under § 10(b) and Rule 10b-5. Because § 10(b) and Rule 10b-5 are nearly identical to the removal criteria set forth at § 78bb(f)(1) of SLUSA, it follows that removal is improper, and remand to state court is the appropriate course."). Thus, the Second Circuit's approach

invites a slippery slope where arguably, even purchaser/seller class actions could end up in state court as negligence class actions. That path is inconsistent with SLUSA's goals of national uniformity and ending vexatious securities lawsuits. Instead, this Court should grant certiorari and establish a nationwide rule that SLUSA's "preemptive effect is not confined to knocking out state-law claims by investors who have *winning* federal claims, as plaintiffs suppose. It covers both good and bad securities claims – *especially* bad ones." *Kircher*, 403 F.3d at 484.

CONCLUSION

For the foregoing reasons, the Court should grant certiorari.

Respectfully submitted,

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No. 04-1371

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JOINT APPENDIX

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PETITION FOR CERTIORARI FILED APRIL 11, 2005
CERTIORARI GRANTED SEPTEMBER 27, 2005

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The following opinions, statutes, regulations and brief have been omitted in printing this joint appendix because they appear on the following pages in the appendix to the Petition for a Writ of Certiorari:

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APPENDIX A — RELEVANT DOCKET ENTRIES OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

GENERAL DOCKET
US Court of Appeals for the Second Circuit

Court of Appeals Docket #:03-7499-cv

Nsuit: 3850 STATUTES-Secur Comm Exchange
Dabit v. Merrill Lynch Filed: 5/14/03

Appeal from: SDNY (NEW YORK CITY)

Case type information:
Civil
Private

None

Lower court information:
District: 02-cv-8472

Trial Judge Milton Pollack
MagJudge:
Date Filed: 10/23/02

Date order/judgement: 4/10/2003
Date NOA filed: 5/9/2003

Appendix A

Fee status:Paid
Panel Assignment:

Panel: JLO SS RCW 40 Foley Sq.
Date of decision 1/11/05

Prior cases: NONE

Current cases: NONE

Docket as of April 25, 2005 7:11 pm

Docket No. [s] : 03-7499-cv(L), 03-7458-cv(CON)

SHADI DABIT, on behalf of himself and all others similarly situated, IJG INVESTMENTS and IRLYS GUY, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a corporation and MERRILL LYNCH & CO., INC.,

Defendants-Appellees.

Appendix A

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* * *

Appendix A

6/11/03 Scheduling order #1 filed. Record on appeal due on 7/28/03. Appellant's brief and appendix due on 8/1/03. Appellee's brief due on 9/5/03. Argument as early as week of 10/20/03. It is recommended that this appeal be heard in tandem with 03-7458, IJG v. Merrill Lynch. (SB)

6/11/03 Ordered that the following appeals Docket Nos: 03-7458 are to be heard together. SEE SCHEDULING ORDER #1.

* * *

7/8/03 Letter dated 6/16/03 from William B. Federman notifying the Court that this appeal and appeals no. 03-7458 and 03-7999 are not similar and should not be consolidated received

* * *

8/1/03 Appellant Shadi Dabit brief FILED with proof of service.

8/1/03 Appellant Shadi Dabit joint appendix filed w/pfs. Number of volumes: 1.

* * *

9/5/03 Appellee Merrill Lynch, Pier brief filed with proof of service.

Appendix A

9/22/03 Appellant Shadi Dabit reply brief filed with proof of service.

* * *

12/15/03 Case heard before OAKES, SOTOMAYOR, WESLEY, C.JJ. . (TAPE: CD dated: December 15, 2003)

* * *

3/22/04 Letter sent to Allan Capute: requesting an amicus brief.

3/22/04 Notice to counsel in re: 3/22/04 letter sent requesting amicus brief.

Dear Mr. Capute:

The panel in the above-referenced appeals would like to invite the SEC to submit its views on these cases with regard to the questions listed below:

1. Whether the jurisprudence interpreting "in connection with" under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("§ 10(b)"), and Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5"), should be adopted for the Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. §§ 77p and 78bb(f) ("SLUSA")?

2. Whether the purchaser-seller rule of standing or otherwise enunciated in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), should be adopted for SLUSA, so that an action will be preempted under SLUSA only if the action alleges that the plaintiff(s) actually purchased or sold a security as a result of the alleged misrepresentation or omission?

3. Whether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5?

4. Where a brokerage allegedly issued intentionally false and biased research reports to garner investment banking business, whether the following state law claims arising from that activity meet SLUSA's "in connection with" requirement:

(a) claims brought by the brokerage's clients for annual flat fees paid to the brokerage for unbiased investment research, which fees are not triggered by any actual purchases or sales of securities;

(b) claims brought by the brokerage's clients for commissions fees paid to the brokerage for investing in securities recommended by the biased research;

(c) claims brought by the brokerage's broker-employees for investment losses suffered in retaining securities as a result of the brokerage's falsely touting the securities' values; and

(d) claims brought by the brokerage's broker-employees for the loss of future commissions to be paid by their clients who left the brokerage as a result of the biased research?

5. Whether the SEC takes a position on any other claims or arguments raised by the parties in these cases?

The Court hereby respectfully requests that the Securities and Exchange Commission submit its response addressing these questions, within forty-five (45) days after the date of this letter. Upon the request of the Commission, I will furnish the Commission with a copy of the briefs and the appendices on appeal in these cases.

The parties are allowed fifteen (15) days to respond to the SEC's submission. The parties response is limited to ten (10) typewritten, single-spaced pages.(RBM)

* * *

Appendix A

6/22/04 AMICUS CURIAE SEC, brief filed (as per the Court's 3/22/04 order) with proof of service.

* * *

1/11/05 Judgment of the district court is Affirmed in part and Vacated and Remanded in part by published signed opinion filed. (SS)

* * * *

APPENDIX B— RELEVANT DOCKET ENTRIES OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK (FOLEY SQUARE)

U.S. District Court
Southern District of New York (Foley Square)
CIVIL DOCKET FOR CASE #: 1:02-cv-08472-MP

Dabit v. Merrill Lynch	Date Filed: 10/23/2002
Assigned to: Judge Milton Pollack	Jury Demand: None
Demand: $0	Nature of Suit: 850 Securities/Commodities
	Jurisdiction: Federal Question

Case in other court: USDC-WDOK, 5:02-cv-564
MDL PANEL, MDL1484
Cause: 28:1331 Fed. Question: Other

No. 1:02-cv-08472-MP

SHADI DABIT,
on behalf of himself and all others similarly situated,

Plaintiff,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
a corporation,

Defendant.

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Appendix B

Date Filed	**Docket Text**
10/23/2002	CERTIFIED TRUE COPY OF CONDITIONAL MDL TRANSFER IN ORDER FROM THE MDL PANEL . . . transferring action from the U.S.D.C. for the Western District of Oklahoma, Docket No.: 5:02-cv-564, MDL No.: 1484,, to the S.D.N.Y. Mailed letter requesting transfer of their file. (jol) (Entered: 10/28/2002)
	* * *
11/10/2002	MDL TRANSFER IN: Received certified copy of docket entries and file from the District of Western District Oklahoma, Docket No.: 5:02cv564(SPF), MDL No.: 1484. (gmo) (Entered: 11/19/2002)
	* * *
02/07/2003	NOTICE OF MOTION by Merrill Lynch, for an Order pursuant to FRCP 12(b)(6) dismissing the complaints for failure to state a claim upon which relief may be granted . Return Date 4/10/03 at 10:30 a.m. Exhibits A through D are attached. ORIGINAL ENTERED IN CASE #02 MDL 1484 (MP), DOC. #174. (tp) (Entered: 03/05/2003)

Appendix B

02/07/2003	MEMORANDUM OF LAW by Merrill Lynch in opposition to the remand motions of Ciccarelli, IJG Investments, and Smith and in support of their [0-1] motion for an Order pursuant to FRCP 12(b)(6) dismissing complaints for failure to state a claim upon which relief may be granted. (tp) (Entered: 03/05/2003)
03/12/2003	MEMORANDUM OF LAW AND RESPONSE AND OBJECTION by Shadi Dabit re: [0-1] motion for an Order pursuant to FRCP 12(b)(6) dismissing the complaints for failure to state a claim upon which relief may be granted . (yv) (Entered: 03/13/2003)
04/10/2003	OPINION AND DECISION # 88340, denying [0-1] motion for an Order pursuant to FRCP 12(b)(6) dismissing the complaints for failure to state a claim upon which relief may be granted; the motions to remand the Ciccarelli, IJG Investments, and Smith actions are denied . (signed by Judge Milton Pollack); (Orig. doc. filed in case 02 MD 1484, Doc. #222) (ae) (Entered: 04/10/2003)
05/09/2003	NOTICE OF APPEAL by Shadi Dabit from [0-1] order the motions to remand the Ciccarelli, IJG Investments, and Smith actions are denied . Copies of notice of appeal mailed to Attorney(s) of Record: Skadden, Arps, Slate, Meagher & Flom, LLP,

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	Seeger Weiss, LLP, Trujilo, Rodriguez & Richards, LLC, Schoengold & Sporn, P.C. and Kaplan, Fox & Kilsheimer, LLP. $105.00 Appeal filing fee paid 5/14/03 on receipt # E 473580. (dt) (Entered: 05/14/2003)
05/14/2003	Notice of appeal and certified copy of docket to USCA: [3-1] appeal by Shadi Dabit ; Copy of notice of appeal sent to District Judge. (dt) (Entered: 05/14/2003)

* * *

07/31/2003	JUDGMENT; that for the reasons stated in the Court's Opinion (88340) and Order dated 4/10/03, defendant's motions to dismiss all the complaints are granted and the motions to remand the Ciccarelli, ILG Investments, and Smith actions are denied. (signed by J. Michael McMahon, Clerk of Court); Entered On Docket: 8/7/03. (ae) (Entered: 08/07/2003)

* * *

08/26/2003	Transcript of record of proceedings before Judge Milton Pollack on 4/10/03. (kw) (Entered: 08/26/2003)

* * * *

APPENDIX C — RELEVANT DOCKET ENTRIES OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA (OKLAHOMA CITY)

U.S. District Court
Western District of Oklahoma[LIVE] (Oklahoma City)
CIVIL DOCKET FOR CASE #: 5:02-cv-00564

Dabit v. Merrill Lynch Pierce	Date Filed: 04/26/2002
Assigned to:	
Honorable Stephen P. Friot	Jury Demand: Both
Demand: $75,000	Nature of Suit: 190
Cause: 28:1332	Contract: Other
Diversity-Other Contract	Jurisdiction: Diversity

No. 5:02-cv-00564

SHADI DABIT,
on behalf of himself and all others similarly situated,

Plaintiff,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
a corporation,

Defendant.

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Plaintiff
Shadi Dabit
on behalf of himself and all others similarly situated

represented by

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V.

Defendant
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a corporation

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Appendix C

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Appendix C

Date Filed	Docket Text
04/26/2002	COMPLAINT (eh) (Entered: 04/29/2002)
	* * *
05/16/2002	OPPOSED MOTION by defendant Merrill Lynch Pierce to extend time to answer or otherwise respond to plf's class action compl (ap) (Entered: 05/17/2002)
05/17/2002	ORDER by Honorable Stephen P. Friot granting dft's motion to extend time until 7/18/02 to answer or otherwise respond to plf's class action compl [7-1] (cc: all counsel) [EOD Date 5/17/02] (ap) (Entered: 05/17/2002)
05/17/2002	OPPOSITION by plaintiff Shadi Dabit to dft's motion to extend time to answer or otherwise respond to plf's class action compl [7-1] (ap) (Entered: 05/17/2002)
05/20/2002	COMBINED MOTION by plaintiff Shadi Dabit to reconsider order granting enlargment of time to answer and Brief in Support (nm) (Entered: 05/21/2002)
05/22/2002	ENTER ORDER by Honorable Stephen P. Friot re [10-1] a hrg on Plf's Motion to Reconsider Order Granting Enlargement of Time to Answer is hereby set for Friday

5/24/02 @ 3:00 pm before Judge Friot ctrm #401 (cc: all counsel) [EOD Date 5/22/02] (nm) (Entered: 05/22/2002)

* * *

05/28/2002 ENTER ORDER by Honorable Stephen P. Friot GRANTED motion to reconsider order granting enlargment of time to answer [10-1] The court reaffirms its Order of 5/17/02. The court waives the Rule 26 provision barring disc prior to a disc conf, to the following extent only: Plf is authorized to serve a Rule 34 doc request on Dft at any time hereafter, if Plf desires to do so. Dft's responses to any such Rule 34 doc request shall be due not later than 7/18/02 (cc: all counsel) [EOD Date 5/28/02] (nm) (Entered: 05/28/2002)

06/10/2002 MOTION by plaintiff Shadi Dabit for particularized expedited discovery fm third-pty witnesses to preserve evidence and brf in supp (ap) (Entered: 06/11/2002)

06/27/2002 NOTICE of Filing with the Judicial Panel on Multi-District Litigation Motion to Stay Proceedings by defendant Merrill Lynch Pierce (ap) (Entered: 06/28/2002)

06/27/2002 MOTION by defendant Merrill Lynch Pierce to stay proceedings (ap) (Entered: 06/28/2002)

* * *

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06/28/2002	OPPOSED MOTION by defendant Merrill Lynch Pierce for enlargement of time to resp to plf's mtn for particularized expedited discovery fm 3rd-pty witns to preserve evidence and brief in supp (ap) (Entered: 06/28/2002)
07/02/2002	ORDER by Honorable Stephen P. Friot granting dft's motion for enlargement of time to resp to plf's mtn for particularized expedited discovery fm 3rd-pty witns to preserve evidence [17-1] Response due 7/9/02 (cc: all counsel) [EOD Date 7/2/02] (cjs) (Entered: 07/02/2002)
07/05/2002	DOCKET status/scheduling ; status scheduling conf set for 1:30 8/6/02 (cjs) Modified on 07/31/2002 (Entered: 07/05/2002)
07/05/2002	RESPONSE by plaintiff Shadi Dabit to motion to stay proceedings [15-1], motion for particularized expedited discovery fm third-pty witnesses to preserve evidence [14-1] (cjs) (Entered: 07/08/2002)
07/08/2002	ORDER by Honorable Stephen P. Friot denying dft's motion to stay proceedings [15-1], denying dft's Notice of Filing with the Judicial Panel on Multi-district Litigation/notice [15-1] (cc: all counsel) [EOD Date 7/8/02] (cjs) (Entered: 07/08/2002)

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07/09/2002	OBJECTION by defendant Merrill Lynch Pierce to plf's motion for particularized expedited discovery fm third-pty witnesses to preserve evidence [14-1] and brief in support (ap) (Entered: 07/10/2002)
07/10/2002	ORDER by Honorable Stephen P. Friot denying motion for particularized expedited discovery fm third-pty witnesses to preserve evidence [14-1] (more fully set out) (cc: all counsel) [EOD Date 7/10/02] (fp) (Entered: 07/10/2002)
07/11/2002	RENEWED MOTION by defendant Merrill Lynch Pierce for stay of proceedings pending mtn bef the Judicial Panel on MDL, or in the alternative, an extension of time to coordinate the response (ap) (Entered: 07/12/2002)
07/12/2002	SUPPLEMENT by defendant Merrill Lynch Pierce re renewed motion for stay of proceedings pending mtn bef the Judicial Panel on MDL [23-1], or in the alternative an extension of time to coordinate the response [23-2] (ap) (Entered: 07/15/2002)
07/15/2002	ENTER ORDER by Honorable Stephen P. Friot bef the Ct is dft's renewed mtn to stay of proceedings pending mtn bef the Judicial Panel on MDL or in the alternative an ext of time to coordinate resp, filed on 7/11/02 and

dft's suppl to the renewed mtn filed on 7/12/02; the request for an extension of time to answer [23-2] is DENIED; the Ct will address the renewed mtn for stay after plf has responded to the mtn; plf's response is due by 7/29/02 (cc: all counsel) [EOD Date 7/15/02] (ap) (Entered: 07/15/2002)

07/18/2002 MOTION by defendant Merrill Lynch Pierce to dismiss complaint and memorandum of law (ap) (Entered: 07/19/2002)

07/23/2002 COMBINED MOTION by plaintiff Shadi Dabit to compel dft to respond to discovery requests and brief in support (ap) (Entered: 07/23/2002)

07/25/2002 MOTION by defendant Merrill Lynch Pierce to stay discovery , and for protective order and brf in supp (ap) (Entered: 07/26/2002)

07/29/2002 RESPONSE by plaintiff Shadi Dabit to dft's renewed motion for stay of proceedings pending mtn bef the Judicial Panel on MDL [23-1] or in the alternative, an ext of time to coordinate response (ap) (Entered: 07/30/2002)

07/31/2002 ENTER ORDER by Honorable Stephen P. Friot all pending motions in this matter re [28-1], [28-2], [27-1], [23-1], other than the motion to dismiss, are set for hearing;

hearing set on 8/16/02 at 8:30 am; pending that hearing, all discovery proceedings and discovery activity in this action are stayed (cc: all counsel) [EOD Date 7/31/02] (ap) Modified on 09/18/2002 (Entered: 07/31/2002)

* * *

08/05/2002 RESPONSE and Ojbection by plaintiff Shadi Dabit to dft's motion to dismiss complaint [26-1] (ap) (Entered: 08/06/2002)

* * *

08/08/2002 MOTION by defendant Merrill Lynch Pierce for leave to file reply brf (ap) (Entered: 08/09/2002)

08/09/2002 ORDER by Honorable Stephen P. Friot granting dft's motion for leave to file reply brf [34-1]; the Ct grants dft 10 days fm the date of this order to file reply brf not to exceed 10 pgs in length (cc: all counsel) [EOD Date 8/9/02] (ap) (Entered: 08/09/2002)

08/12/2002 RESPONSE by defendant Merrill Lynch Pierce to plf's motion to compel dft to respond to discovery requests [27-1] (ap) (Entered: 08/13/2002)

* * *

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08/14/2002	MOTION by plaintiff Shadi Dabit for leave to reply to Dft's response to Plfs motion to compel (nm) (Entered: 08/14/2002)
08/15/2002	ORDER by Honorable Stephen P. Friot granting pla's motion for leave to reply to Dft's response to Plfs motion to compel [38-1] pla may file reply to dft's mtn to compel w/in 5 days of the date of this order (cc: all counsel) [EOD Date 8/15/02] (cjs) (Entered: 08/15/2002)
08/15/2002	REPLY by plaintiff Shadi Dabit to response to motion to compel dft to respond to discovery requests [27-1] (kw) (Entered: 08/16/2002)
08/19/2002	REPLY by defendant Merrill Lynch Pierce to plf's response to dft's motion to dismiss complaint [26-1] (ap) (Entered: 08/20/2002)
09/16/2002	MOTION HEARING COURTROOM MINUTES: Before the Honorable Stephen P Friot; plf's cnsl William Federman, Clell Cunningham; dft's cnsl Bruce Day, Bill Guest; the Court takes under advisement re [28-1], [28-2], [27-1], [23-1] (ap) (Entered: 09/16/2002)
09/18/2002	ORDER by Honorable Stephen P. Friot the renewed motion for stay [23-1] is DENIED; the July 25, 2002 motion to stay discovery

[28-1], [28-2] is DENIED, however, discovery is stayed until the status and sched conf to be held October 4; the motion to compel [27-1] is GRANTED; the timing of document production will be discussed at the October 4, 2002 status and sched conf (cc: all counsel) [EOD Date 9/18/02] (ap) (Entered: 09/18/2002)

* * *

10/09/2002 ORDER by Honorable Stephen P. Friot although the Ct suggested in its September 18 order re [43-1] that it would proceed to determine the timing of document prod, the Ct has, upon further consideration, concluded that all matters w/respect to discovery, including determination of the timing of doc prod, should await the Ct's ruling on the mtn to dism; if the mtn is granted, discovery matters will be moot; if it is not granted, the proper course will likely be much easier to determine; accordingly, the stay of discovery previously ordered by the court shall remain in place until the court rules on the pending mtn to dism (cc: all counsel) [EOD Date 10/9/02] (ap) (Entered: 10/09/2002)

10/11/2002 ORDER by Honorable Stephen P. Friot GRANTS motion to dismiss complaint [26-1] dismissing the complaint [1-1] Plf's

is granted lv to file an amended cmp w/i (10) days after the date of this order. In the amended cmp, plf is at liberty to plead any conbination of state and fed clms, in the alternative or otherwise, but state clms must be differentiated fm federal clms, in terms of the substantive bases for liability and in terms of causation and damges. (cc: all counsel) [EOD Date 10/11/02] (fp) (Entered: 10/11/2002)

10/21/2002 NOTICE to the Court of Transfer Order entered by Judicial Panel on MDL by defendant Merrill Lynch Pierce (ap) (Entered: 10/22/2002)

10/21/2002 FIRST AMENDED CLASS ACTION COMPLAINT by plaintiff Shadi Dabit; jury demand (ap) (Entered: 10/22/2002)

* * *

11/04/2002 TRANSFER ORDER, by Wm Terrell Hodges, Chairman, that pursuant to 28 USC 1407, the actions listed on the attached Sched A and pending outside the SD/NY are transf to the SD/NY and w/consent of that court, assigned to the Honorable Milton Pollack for coordinated or consolidated pretrial prcdgs with the actions pending there; Case transferred to the: SD/NY (cc: all counsel) [EOD Date 11/4/02] (ap) (Entered: 11/04/2002)

* * * *

APPENDIX D — CLASS ACTION COMPLAINT DATED APRIL 26, 2002

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

Case No. CIV 02-564-F

SHADI DABIT,
on behalf of himself and all others similarly situated

Plaintiff,

v.

MERRILL LYNCH PIERCE FENNER SMITH, INC., A CORPORATION

Defendants.

CLASS ACTION COMPLAINT

Plaintiff makes the following allegations upon information and belief except as to allegations specifically pertaining to plaintiff and his counsel, based on the facts alleged below, predicated upon the investigation undertaken by plaintiffs counsel, Plaintiff believes that further substantial evidentiary support will exist for the allegations set forth below after a reasonable opportunity for discovery.

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NATURE OF THE ACTION

1. This is a class action brought by plaintiff on behalf of himself and all other former or current account executives ("Brokers"), who, while employed by Defendant, Merrill Lynch Pierce Fenner & Smith, Inc. ("ML") purchased one or more of the ML recommended securities identified in *Exhibit A*, attached hereto (the "ML Stocks"), individually or on behalf of Brokers' clients at any time during the period from December 1, 1999 through December 31, 2000 (the "Class Period"), and who suffered damages as a result of owning and holding such ML Stocks during this time period, or who suffered damages as a consequence of the loss of clients due to ML's wrongful actions.

2. Plaintiff alleges that ML, after Plaintiffs purchase of the ML Stocks, individually or on behalf of clients of Plaintiff, failed to advise Plaintiff of the fact of the decreasing values of the ML Stocks, and misrepresented to Plaintiff that the ML Stocks were worthy of holding in Plaintiffs or Plaintiff's clients' portfolio, all in violation of ML's fiduciary duty to Plaintiff and in violation of ML's covenant of good faith and fair dealing.

3. When the true value of the ML Stocks became apparent and clients of Plaintiff terminated their relationship with Plaintiff, Plaintiff suffered damages in the form of lost commissions that would otherwise have been earned from future business with such clients.

4. Throughout the Class Period the price of the ML Stocks promoted by ML were artificially inflated as a result of the

manipulative efforts of ML. As a result of the efforts of ML and its agents, employees and affiliates, ML was able to, and did, manipulate the price of the ML Stocks, causing these stocks to trade at artificially inflated prices throughout the Class Period.

5. Further, after regulatory authorities in the State of New York initiated investigations concerning ML's conduct, in June, 2001, and as pressure from those investigations increased, ML ceased manipulating the price of various stocks, and, as a result, the price of certain stocks steadily declined, leaving Plaintiff and clients of Plaintiff who purchased these stocks at manipulation-inflated prices with substantial losses. ML failed to advise Plaintiff of the fact of the investigations and the certain subsequent decline in the ML Stocks' values, thereby preventing Plaintiff from selling his personally held stocks at a minimal loss, and further preventing Plaintiff from advising his clients to similarly sell such ML Stocks in their individual portfolios.

6. ML, acting as a central nerve center in the manipulation of various stocks identified by the New York Attorney General ("NYAG"), perpetrated this stock manipulation through a variety of deceptive devices, artifices, and tactics that are the hallmarks of stock manipulation.

7. Plaintiff, in reliance on the continuing positive recommendations of ML with respect to the ML Stocks, retained them in his portfolio and recommended to his clients that they, too, hold such stocks, when, had he been advised of the true facts, would have sold them and advised his clients to sell them well before the ML Stocks dramatically declined in value.

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8. First, ML demanded that brokers in its various retail offices throughout the country sell the ML Stocks to public customers without regard to the propriety of these stocks as an investment for these customers. This was done to artificially create a market for the ML Stocks. ML withheld from its Brokers material information it knew about the stocks, including the fact of its artificial support of the price of such stocks.

9. ML regularly and systematically disseminated instructions to its brokers that they were required to identify and promote to customers of ML the ML Stocks, to whom such brokers would, in turn, recommend to their customers the purchase of these stocks. The company-wide demand for such purchases resulted from a systemic policy that brokers actively recommend and solicit purchases of these ML Stocks.

10. Second, ML systematically taught and encouraged its brokers to tell public customers not to sell the ML Stocks and utilized manipulative techniques to prevent such sales or otherwise make selling these stocks onerous. Again, ML never disclosed to its brokers the real basis for its recommendations to purchase the ML Stocks or to retain such stocks once purchased.

11. ML required its brokers to discourage and in some cases to refuse to allow customers to execute sell orders relating to ML Stocks.

12. Third, ML and certain of its agents, employees and affiliates opened brokerage accounts with ML for the purpose of engaging in the trading of ML Stocks.

13. Fourth, ML through its "research department" issued falsely favorable reports about ML Stocks without disclosing the manipulative scheme, or the exceptional relationships between these stocks and the investment banking arm of ML. These reports were distributed to ML brokers in their efforts to solicit purchases of these stocks. ML brokers were directed to rely upon these false reports and were further directed to not rely on any non-ML generated sources of information. In addition, these deceptive reports were disseminated to individuals not affiliated with ML in an effort to encourage widespread purchasing of these stocks and to artificially support the stocks prices.

14. In addition to the illegal sales efforts of ML, ML also artificially propped up the price of various ML Stocks by refusing to execute and otherwise actively discouraging the execution of orders to sell these stocks. These efforts improperly restrained investor selling, caused the supply of these stocks in the marketplace to be understated, caused the demand for these ML Stocks in the marketplace to be overstated, and, as a result, further caused the price of these stocks to be artificially inflated.

15. Plaintiff incorporates herein by reference all of the factual allegations of Eric R. Dinallo, Chief of the Investment Protection Bureau of the New York State Department of Law, also filed in the Supreme Court of the State of New York, County Of New York, a copy of which (without exhibits[1]) is attached hereto as *Exhibit B*.

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1. A copy of the exhibits to such affidavit will be provided to the Court and to counsel for ML upon request.

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16. ML's motive was clear: to enhance and support its competitive edge in its underwriting business by keeping the prices of stocks of companies for which it performed underwriting business at artificially elevated levels, all to ML's personal benefit and to the detriment of Plaintiff. As a result of ML's efforts, the stature of such companies was elevated, and those companies were better able to use their stock as currency in transactions and generally enjoyed enhanced reputations. ML would then use such stature to advertise for and attract further and additional investment banking business. ML would often pursue investment banking deals by touting the support its retail brokers could give to a stocks price thereby enriching the executives of ML's potential investment banking clients. Many of the false and misleading research recommendations on ML Stocks were also used to aid ML in its attempt to build its franchise in the internet and data services sector, where it theretofore had almost no market share or presence.

17. In the case of the ML Stocks, ML successfully propped up the price of these stocks and in exchange received numerous lucrative underwriting and investment banking engagements from such companies as well as other companies.

18. By propping up stocks that ML's "research department" recommended — purportedly on the basis of sound financial analysis — ML sought to establish its "research department" personnel as credible securities analysts in an effort to bolster an overall image of legitimacy.

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19. Finally, by artificially inflating and/or artificially supporting the price of the ML Stocks, ML was able to generate larger investment banking fees for itself and higher volumes of investment banking fees, all to the detriment of Plaintiff and other Brokers and in violation of its fiduciary duties to Plaintiff and other Brokers.

JURISDICTION AND VENUE

20. The claims asserted herein arise under and pursuant to a breach of ML's fiduciary duty to Plaintiff and other Brokers and breach of the covenant of good faith and fair dealing between ML and its Brokers.

21. This Court has jurisdiction of this action pursuant to 28 U.S.C. § 1331 diversity jurisdiction. The amount in controversy exceeds $75,000.00.

22. Venue is properly laid in this District. Many of the acts and conduct complained of, including orchestration of a fum-wide manipulation of stocks by ML through its various branch brokerage offices around the world, emanated from and occurred in this district. Plaintiff resides in this district.

23. ML maintained a fully staffed brokerage office in Oklahoma City, Oklahoma at all relevant times, and conducted many of the acts complained of herein in this district.

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PARTIES

24. Plaintiff Shadi Dabit is a former ML broker who owned and held many of the ML Stocks during the Class Period, and has been damaged thereby. Plaintiff had numerous clients that purchased and held the ML Stocks on the basis of ML's recommendations, and thereafter terminated their relationship with Plaintiff upon learning of the true value of such stocks.

25. Defendant ML touts itself as one of the world's largest full service securities brokerage and investment banking firms, and maintains branch offices in locations throughout the world.

26. ML also touts itself as one of the world's leading financial management and advisory companies, with offices in 38 countries and total client assets of approximately S1.5 trillion. As an investment bank, ML has mushroomed to be a global underwriter of debt and equity securities and strategic advisor to governments, corporations and institutions and individuals worldwide. Through ML Investment Managers, ML is one of the world's largest managers of financial assets.

HISTORY OF THE PROBLEM

27. On June 14, 2001, the United States House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (the "Subcommittee") began holding a hearing entitled "Analyzing the Analyst: Are Investors Getting Unbiased Research From Wall Street?" In his opening remarks, representative Paul E. Kanjorski, the ranking democratic member of the Subcommittee, stated:

> Unlike some other sources of investment advice, the vast majority of the general public has usually

considered the research prepared by Wall Street experts as reliable and valuable. With the burst of the high tech bubble, however, came rising skepticism among investors concerning the objectivity of some analysts over optimistic recommendations. Many in the media have also asserted that a variety of conflicts of interest may have gradually depreciated analysts' independence during the internet craze and effected the quality of their opinions. We have debated the issues surrounding analysts' independence for many years. After the deregulation of trading commissions in 1975, Wall Street firms began using investment banking as a means to compensate their research departments, and within the last few years the tying of analyst compensation to investment banking activities has become increasingly popular. As competition among brokerage firms for IPO's, mergers and acquisitions grew, so did the potential for large compensation packages for sale-side analysts. These pay practices, however, may have also effected analysts' independence. While some brokerage houses suggest that they have executed an impenetrable Chinese wall that divides analyst research from other firm functions like investment banking and trading, the truth, as we have learned from many recent news stories, is that they must initiate a proactive effort to rebuild their imaginary walls.

The release of some startling statistics has also called in to question the actual independence of

analyst. A report by First Call, for example, found that *less than 1% of 28,000 recommendations issued by brokerage analysts during the late 1999's and most of 2000 called for investors to sell stocks in their portfolios.* Within the very same time frame, the NASDAQ composite average fell dramatically. In hindsight, these recommendations appear dubious. Furthermore, First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts *rose from 6:1 in the early 1990's to 100:1 in 2000.* Many parties have consequently suggested that analysts may have become merely cheerleaders for the investment banking division in their brokerage houses. I agree. To me, it appears we may have obsequious analysts instead of objective analysts.

28. The erosion of analysts' objectivity that Rep. Kanjorski discussed was particularly manifest at ML, which employed several well-known analysts who had substantial influence on Wall Street.

29. Throughout the Class Period ML's ratings, reports, and recommendations regarding the ML Stocks were false and contained misleading statements, designed to artificially inflate and artificially support the price of the ML Stock. Rather than providing unbiased research and recommendations as publicly advertised and proclaimed, ML acted for its own self interest as an investment banker, participating in deal making and business generating activities in the hope of securing lucrative investment banking fees and substantial compensation for itself, at the expense of its brokers and customers.

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30. Plaintiff, while employed as a ML broker, was not aware of the conflicts of interest that lay at the heart of ML's research and analysis department, with the consequence that the securities he bought and held, individually and on behalf of his clients, which reflected the materially false and misleading reports in statements by ML, were artificially inflated and artificially supported throughout this period of time. Plaintiff, believing in the integrity of his employer and the ML Stocks' market prices as presented by ML, was damaged as a result of ML's unlawful conduct as described herein and saw his customers abandon him when the value of their portfolios evaporated.

HISTORY OF THE ANALYSTS

31. ML securities analysts who were employed by ML during the operative times reflected herein published two types of reports which were received by investors. Brokers for institutional investors received lengthy detailed reports while brokers for individuals received very short non-descriptive reports. Plaintiff and, in turn, his clients, relied on the reports and ratings which ML knew were not accurate and incorrect.

32. Historically, ML performed both investment banking and research analysts functions, but ML allegedly maintained a "Chinese" wall between the two functions to ensure that the analysts' research and recommendations remained "objective" and were not influenced by ML's interest in attracting and retaining investment banking business.

33. In recent years, however, the Chinese wall either crumbled or turned into rice paper, with research analysts

directly performing investment banking functions and receiving compensation based on their contributions to generating investment banking business, including underwriting initial public offerings and secondary offerings of equity securities, underwriting debt offerings and performing services in merger and acquisition transactions without disclosing material conflicts of interest to the investing public or ML's Retail Brokers.

34. During the Class Period ML made materially false and misleading statements designed to encourage Plaintiff and Plaintiff's clients to purchase ML Stocks. The recommendations were based not on objective analysis, but rather on ML's desire to attract and retain investment banking business for ML. ML's ratings, recommendations and positive comments regarding various stocks, including ML Stocks in which ML was a market maker during this period of time, were improperly influenced by their desire to increase their revenues and the undisclosed personal compensation of the analysts who were benefitting thereby.

35. The conflict of interest for ML's analysts remained undisclosed as they continued to inflate ratings and recommendations for various stocks, including ML Stocks, throughout late 1999 and early 2000. ML knew or should have known that the financial condition and future business prospects of the corporations behind these stocks did not support ML's positive comments and buy recommendations, but ML nevertheless continued to issue positive reports encouraging investors, including Plaintiff to purchase and/or hold the ML Stock.

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36. In some cases, ML simply refused to downgrade its stock recommendations because that would potentially impair ML's ability to generate additional investment banking business that ML wished to underwrite.

37. ML's efforts were designed to, and did, effect an artificial inflation of the price of ML Stocks, while simultaneously attracting and retaining the underlying corporations as ML investment banking clients.

38. After the market for internet and technology stocks collapsed in the first quarter of 2000, journalists, academics, and others began to expose the truth about the roles of analysts, including those at ML.

39. The conflicts of interest exhibited by ML analysts also began to draw the attention of various state and federal government authorities. ML did not timely disclose to Plaintiff that regulators were investigating ML's practices as described herein.

40. During the Class Period, ML continually promoted its stocks in the press, on television and the internet. This publicity campaign was intended to and did assure Plaintiff of ML's alleged integrity and expertise and reached not only investors who were brokerage customers of Plaintiff at ML, but also individual investors, not ML customers.

41. At the height of the internet boom in late 1999 and early 2000, ML analysts were virtually indistinguishable from their investment bankers. This material fact, however, was not disclosed in connection with ML's ratings, recommendations

and other statements regarding the stocks ML was pumping up. ML also withheld this fact from Plaintiff.

42. Unlike firms that did not do investment banking business, ML continued to keep or hold buy recommendations and continued to make highly complimentary comments about corporations with whom ML had done initial public offerings ("IPO"s) and whose stock prices were subsequently being pumped up or supported by ML in the secondary market.

43. When the price of these favored ML Stocks began to fall with the rest of the technology and internet market declines in the mid 2000's, ML still did not downgrade these stocks but instead continued to tout these ML Stocks ideas as excellent investments.

44. In some cases ML kept stock prices of ML Stocks from subsequently falling by continuing its campaign of false and misleading statements, including buy and strong buy recommendations.

45. ML's unlawful conduct allowed them to gain millions of dollars in investment banking fees during this period of time and allowed the analysts to receive millions of dollars in salaries and cash bonuses due to their false and misleading ratings, recommendations and pumped up statements.

46. During the time of the tech rise ML allowed analysts to personally buy and sell shares of stocks they followed.

47. ML, recognizing the problem it created, and as part of its cover up, announced on July 12, 2001, that it would

prohibit research analysts from buying stock in the companies they cover. ML did not, however, self disclose the corrupt system it had implemented and fostered prior to that date.

PLAINTIFF'S CLASS ACTION ALLEGATIONS

48. Plaintiff brings this action as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b)(3) on behalf of himself and on behalf of a class (the "Class") of persons who, while employed by ML as Retail Brokers, purchased or otherwise acquired, individually or on behalf of the Classes' clients, any of the ML Stocks during the period from December 1, 1999 through and including December 31, 2000 (the "Class Period"), and were damaged thereby. Excluded from the Class is the defendant herein; the directors and officers of ML; any corporation, firm, partnership, trust or other person affiliated with any of the foregoing; and the legal representatives, agents, heirs, successors-in-interest or assigns of any excluded person.

49. The members of the Class are so numerous that joinder of all members is impracticable. The precise number of Class members is unknown to Plaintiff at this time but Class members are believed to number in the thousands.

50. Plaintiff will fairly and adequately represent and protect the interests of the members of the Class. Plaintiff has retained competent counsel experienced in class action litigation to further ensure such protection and intend to prosecute this action vigorously.

51. Plaintiffs claims are typical of the claims of the other members of the Class because Plaintiff and all the Class

members' damages arise from and were caused by the same series of deceitful acts undertaken by or chargeable to ML. Plaintiff does not have interests antagonistic to, or in conflict with, the Class.

52. A Class Action is superior to other available methods for the fair and efficient adjudication of this controversy. As the damages suffered by individual class members may be relatively small, the expense and burden of individual litigation make it virtually impossible for most class members individually to seek redress for the wrongful conduct alleged. Plaintiff knows of no difficulty that will be encountered in the management of this litigation that would preclude its maintenance as a class action.

53. Common questions of law and fact exist as to all members of the Class and such questions predominate over any questions affecting solely individual members of the Class. Among the questions of law and fact common to the Class are:

(a) Whether the actions by ML constituted breach of fiduciary duty and breach of the duty of good faith and fair dealing;

(b) whether ML participated directly or indirectly in the concerted action or course of conduct complained of herein;

(c) whether ML artificially inflated or artificially supported recommended stocks through manipulative conduct as complained of herein; and

(d) the extent of injuries sustained by members of the Class and the appropriate measure of damages.

54. The names and addresses of class members, or their prior addresses are available from records maintained by ML. Notice can be provided to Class Members by a combination of published notice and first class mail using techniques and forms of notice similar to those customarily used in similar class actions.

CLAIMS FOR RELIEF

COUNT I

Breach of Fiduciary Duty

55. Plaintiff repeats and realleges each and every allegation contained above.

56. Defendant, directly and indirectly, engaged and participated in a continuous course of deceitful conduct to artificially raise and maintain the artificially inflated and artificially supported market price of the ML recommended stocks during the Class Period.

57. Defendant employed devices, schemes and artifices to defraud and engaged in acts, practices, and a course of conduct as alleged herein to deceive and misrepresent to Plaintiff and Plaintiff's customers the value of and demand for these stocks, which actions breached ML's fiduciary duty to its Retail Brokers.

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58. At the time of the course of conduct alleged above, Plaintiff and the other members of the Class were ignorant of the nature of ML's scheme. Plaintiff and the class members could not in the exercise of reasonable diligence have known the actual facts. Plaintiff and other members of the Class recommended these stocks to their customers and were induced to and did purchase these stocks at artificially inflated and supported prices. Had Plaintiff and other members of the Class known the truth, they would not have taken such action.

59. Defendant ML, with knowledge of, or in reckless disregard of, the conduct complained of herein, caused and permitted the actions which are alleged to have occurred.

60. By virtue of the foregoing, ML violated fiduciary duties to its Retail Brokers.

61. Plaintiff and other members of the Class have been damaged by defendants' violations as described in this Count and seek recovery for the damages caused thereby.

COUNT II

Breach of The Covenant of Good Faith and Fair Dealing

62. Plaintiff repeats and realleges the allegations set forth above as if set forth fully herein.

63. The wrongful acts alleged herein violated ML's requirement of good faith and fair dealing towards Plaintiff and the class members. ML failed to act in a manner

consistent with its representations to the class members or in a manner which a reasonable person would regard as fair and honest or in good faith.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff, on his own behalf and on behalf of the Class, prays for judgment as follows:

A. Declaring this action to be a class action properly maintained pursuant to Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure;

B. Awarding Plaintiff and the other members of the Class damages, including punitive damages, as provided by law;

C. Awarding Plaintiff and other members of the Class their costs and expenses of this litigation, including reasonable attorneys' fees, accountants' fees and experts' fees and other costs and disbursements; and

D. Awarding Plaintiff and other members of the Class such other and further relief as may be just and proper under the circumstances.

Signed this 26th day of April, 2002.

JURY TRIAL DEMANDED

Appendix D

Respectfully Submitted,

s/ William B. Federman
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[Exhibits intentionally omitted because they are set forth as Exhibits to Appendix F at pages 70a-120a.]

APPENDIX E — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA DATED AND FILED OCTOBER 11, 2002

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

Case No. CIV-02-564-F

SHADI DABIT, on behalf of himself and all others similarly situated,

Plaintiffs,

vs.

MERRILL LYNCH PIERCE FENNER & SMITH, INC., a corporation,

Defendant.

ORDER

Before the court is the defendant's Motion to Dismiss, filed July 18, 2002 (docket entry no. 26). The motion invokes only subdivision (6) of Rule 12(b), Fed.R.Civ.P. The plaintiff has responded and the defendant has filed a reply in support of the motion.

At the risk of oversimplification, plaintiff, as the proposed representative of a proposed class of similarly situated individuals (retail brokers employed by defendant during the proposed class period), asserts that, in violation of a common law duty of good faith and fair dealing and in

violation of a common law fiduciary duty, defendant wrongfully induced plaintiff and to purchase and hold, and to cause his clients to purchase and hold, securities for reasons which served defendant's proprietary interests and which were unrelated to the merits of the securities or the interests of the clients, with resultant reputational and other harm to plaintiff and the other class members.

Defendant asserts in its motion that plaintiff's class action claims are preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA), 112 Stat. 3227 (codified in various places in 15 U.S.C.) and that they must be dismissed under the preemptive and preclusive language of SLUSA, 15 U.S.C. §§ 78bb(f)(1). Defendant further asserts that plaintiff's claims should be dismissed because they do not allege a cognizable legal theory under Oklahoma law.

Plaintiff, in response to the motion, argues that his claims are not preempted by SLUSA because his claims are predicated upon having been wrongfully induced to *hold*, rather than *purchase*, covered securities. Plaintiff also requests that "if the court is of the opinion that Dabit's claims are not sufficiently delineated in the Complaint to be beyond the reach of SLUSA, the court should grant Plaintiff leave to amend the Complaint to correct same." Plaintiff's response, at 10. Plaintiff requests, alternatively, that he be granted leave to plead federal securities claims if the court is of the opinion that it would not be possible for plaintiff to allege claims which would not be preempted by SLUSA. Id. Finally, plaintiff argues that, as a matter of Oklahoma law, he has stated claims for breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing.

Appendix E

The court has concluded that the Complaint must be dismissed, with leave to amend. It is clear that, for some purposes, it will likely be necessary to differentiate between claims and damages based on wrongfully-induced purchases, on one hand, and claims and damages based on wrongfully-induced holding, on the other hand. However, the relevant allegations in the Complaint consist of a hopeless melange of purchase-related and holding-related assertions. They simply cannot be sorted out in any meaningful way. Conceptually, it is certainly conceivable that claims based on wrongfully-induced holding could be pleaded. In this respect, it should be noted that, as a matter of Oklahoma law, the court is not impressed with defendant's contention that Merrill Lynch's alleged misdeeds are not actionable at the instance of a retail broker who relied to his detriment upon the allegedly duplicitous research generated by Merrill Lynch. As was explained in *Roberson v. PaineWebber, Inc.*, 998 P.2d 193, 198 (Okla. App. 1999) (cert. denied 2000):

> A fiduciary relationship springs from an attitude of trust and confidence and is based on some form of agreement, either expressed or implied, from which it can be said the minds have been met to create a mutual obligation. [Citation omitted.] In determining whether a fiduciary relationship was established, several factors have been adopted to serve as guide for this fact-driven question. It includes not only all legal relationships, e.g., guardian and ward, attorney and client, but it extends to every possible case from which there is confidence reposed on one side and resulting domination and influence on the other. The

> relationship need not be legal as the relationship may develop because of moral, social, domestic or merely personal relations. The term "fiduciary relationship" is a very broad term and has been applied in circumstances where influence has been acquired and abused and where confidence has been reposed and betrayed. The origin of the confidence and the source of the influence are immaterial. The question is whether a relation in fact exists.

Cf., *Restatement (Second) of Agency*, §§ 434, 437, 470 (esp. Comment *c*, as to which intentional misconduct would present an *a fortiori* case), 472, 473. However, it falls to the plaintiff to allege viable claims which lend themselves to logical analysis. The question of whether a viable free-standing claim can be pleaded, and the related question of whether it will be feasible to fuse state law claims based on *holding* with federal claims based on *purchases* (if plaintiff elects to attempt to do so), will await another day.

The complaint is accordingly DISMISSED. Plaintiff is granted leave to file an amended complaint within ten days after the date of this order. In the amended complaint, plaintiff is at liberty to plead any combination of state and federal claims, in the alternative or otherwise, but state claims must be differentiated from federal claims, in terms of the substantive bases for liability and in terms of causation and damages.

DATED October 11, 2002.

s/ Stephen P. Friot
STEPHEN P. FRIOT
UNITED STATES DISTRICT JUDGE

APPENDIX F — FIRST AMENDED CLASS ACTION COMPLAINT WITH EXHIBITS DATED OCTOBER 21, 2002

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

Case No. CIV-02-564-F

SHADI DABIT,
on behalf of himself and all others similarly situated,

Plaintiff,

v.

MERRILL LYNCH PIERCE FENNER SMITH, INC.,
a corporation

Defendants.

FIRST AMENDED CLASS ACTION COMPLAINT

Plaintiff makes the following allegations upon information and belief, except as to allegations specifically pertaining to plaintiff and his counsel, based on the facts alleged below, predicated upon the investigation undertaken by plaintiff's counsel, Plaintiff believes that further substantial evidentiary support will exist for the allegations set forth below after a reasonable opportunity for discovery.

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NATURE OF THE ACTION

1. This is a class action brought by plaintiff on behalf of himself and all other former or current account executives ("Brokers") who, while employed by Defendant, Merrill Lynch Pierce Fenner & Smith, Inc. ("ML"), owned and continued to own one or more of the ML recommended securities identified in *Exhibit A*, attached hereto (the "ML Stocks"), or recommended such securities to their clients during the period from December 1, 1999 through December 31, 2000 (the "Class Period"), and who suffered damages as a result of owning and holding such ML Stocks during this time period, or who suffered damages as a consequence of the loss of clients due to ML's wrongful actions further described herein.

2. Plaintiff alleges that ML, after Plaintiffs purchase of the ML Stocks, individually or on behalf of clients of Plaintiff, failed to advise Plaintiff of the fact of the decreasing values of the ML Stocks, and misrepresented to Plaintiff that the ML Stocks were worthy of holding in Plaintiff's or Plaintiff's clients' portfolio, all in violation of ML's fiduciary duty to Plaintiffs and in violation of ML's covenant of good faith and fair dealing.

3. When the true value of the ML Stocks and individual portfolios too, became apparent and clients of Plaintiff terminated their relationship with Plaintiff, Plaintiff suffered damages in the form of lost commissions that would otherwise have been earned from future business with such clients.

4. Throughout the Class Period the price of the ML Stocks promoted by ML were artificially inflated as a result of the manipulative efforts of ML. As a result of the efforts of ML and its agents, employees and affiliates, ML was able to, and did, manipulate the price of the ML Stocks, causing these stocks to trade at artificially inflated prices.

5. Further, after regulatory authorities in the State of New York initiated investigations concerning ML's conduct in approximately June, 2001, and as pressure from those investigations increased, ML ceased manipulating the price of various stocks and, as a result, the market value of such stocks declined, leaving Plaintiff and clients of Plaintiff who held these stocks at manipulated inflated prices with substantial losses. ML failed to advise Plaintiff: of its breach of fiduciary duty; its false and artificial support of the ML stocks; the fact of the investigations and the certain subsequent decline in the ML Stocks' values once the investigations became known, thereby preventing Plaintiff from selling his personally held stocks at a minimal loss, and further preventing Plaintiff from advising his clients to similarly sell the ML Stocks in their individual portfolios.

6. ML, acting as a central nerve center in the manipulation of various stocks identified by the New York Attorney General ("NYAG"), perpetrated this stock manipulation through a variety of deceptive devices, artifices, and tactics that are the hallmarks of stock manipulation.

7. Plaintiff, in reliance on the continuing positive recommendations and support of ML with respect to the ML Stocks, retained them in his portfolio and recommended to

his clients that they too hold such stocks, when, had he been advised of the true facts, would have sold them or recommended that clients sell them well before the ML Stocks dramatically declined in value.

8. ML systematically taught and encouraged its Brokers to tell clients to own and hold the ML Stocks. ML never disclosed to its Brokers the real basis for its recommendations to hold such stocks.

9. ML and certain of its agents, employees and affiliates without advising Plaintiff traded against ML's published research recommendations, leaving the Brokers and their clients to provide support for the Company's stock prices.

10. ML caused the ML "research department" to issue falsely favorable reports about ML Stocks without disclosing the manipulative scheme, or the exceptional relationships between these stocks and the investment banking arm and officers of ML. These false reports were distributed to ML Brokers. ML Brokers were directed to rely upon these false reports and were further directed to not rely on any non-ML generated sources of information. In addition, these deceptive reports were disseminated to individuals not affiliated with ML in an effort to artificially support the stocks prices.

11. ML artificially propped up the price of various ML stocks by refusing to execute and otherwise actively discouraging the execution of orders to sell these stocks. These efforts improperly restrained investor selling, caused the supply of these stocks in the marketplace to be understated, caused the demand for the stocks in the

marketplace to be overstated and, as a result, further caused the price of these stocks to be artificially inflated and/or maintained.

12. Plaintiff incorporates herein by reference all of the factual allegations of Eric R. Dinallo, Chief of the Investment Protection Bureau of the New York State Department of Law, also filed in the Supreme Court of the State of New York, County Of New York, a copy of which (without exhibits[1]) is attached hereto as *Exhibit B*.

13. ML's motive was clear: to enhance and support its competitive edge in its underwriting business by keeping the prices of stocks of companies for which it performed underwriting business at artificially elevated levels, all to ML's personal benefit and to the detriment of Plaintiff and members of the class. As a result of ML's efforts, the stature of such companies was elevated, and those companies were better able to use their stock as currency in transactions and generally enjoyed enhanced reputations. ML would then use such stature to advertise for and attract further and additional investment banking business. ML would often pursue investment banking deals by touting the support its retail brokers could give to a stock's price thereby enriching the executives of ML's potential investment banking clients. Many of the false and misleading "research" reports on ML Stocks were also used to aid ML in its attempt to build its franchise in the internet and data services sector, where it previously had almost no market share or presence.

---

1. A copy of the exhibits to such affidavit is a public record and can be provided to the Court and to counsel for ML upon request.

14. In the case of the ML Stocks, ML successfully propped up the price of these stocks and in exchange received numerous lucrative underwriting and investment banking engagements from such companies as well as other companies.

15. By propping up stocks that ML's "research department" recommended —purportedly on the basis of sound financial analysis — ML sought to establish its "research department" personnel as credible securities analysts in an effort to bolster an overall image of legitimacy.

16. Finally, by artificially inflating and/or artificially supporting the price of the ML Stocks, ML was able to generate larger and higher volumes of investment banking fees to the detriment of Plaintiff and members of the class.

JURISDICTION AND VENUE

17. The claims asserted herein arise under and pursuant to a breach of ML's fiduciary duty to Plaintiff and breach of the covenant of good faith and fair dealing between ML and its Brokers.

18. This Court has jurisdiction of this action pursuant to 28 U.S.C. § 1331 (diversity jurisdiction). The amount in controversy exceeds $75,000.00.

19. Venue is properly laid in this District. Many of the acts and conduct complained of, including orchestration of a firm-wide manipulation of stocks by ML through its various branch brokerage offices around the world, emanated from and occurred in this district. Plaintiff resides in this district.

20. ML maintained a fully staffed brokerage office in Oklahoma City, Oklahoma at all relevant times, and conducted many of the acts complained of herein in this district.

PARTIES

21. Plaintiff Shadi Dabit ("Dabit"), as set forth in the accompanying certification, is a former ML Broker who owned and held many of the ML Stocks during the Class Period, and has been damaged thereby.

22. Defendant ML touts itself as one of the largest full service securities brokerage and investment banking firms, and maintains branch offices in locations throughout the world.

23. ML also touts itself as one of the world's leading financial management and advisory companies, with offices in 38 countries and total client assets of approximately $1.5 trillion. As an investment bank, ML has mushroomed to be a global underwriter of debt and equity securities and strategic advisor to governments, corporations and institutions and individuals worldwide. Through ML Investment Managers, ML is one of the world's largest managers of financial assets.

HISTORY OF THE PROBLEM

24. On June 14, 2001, the United States House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (the "Subcommittee") began holding a hearing entitled "Analyzing the Analyst: Are

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Investors Getting Unbiased Research From Wall Street?" In his opening remarks, Representative Paul E. Kanjorski, the ranking democratic member of the Subcommittee, stated:

> Unlike some other sources of investment advice, the vast majority of the general public has usually considered the research prepared by Wall Street experts as reliable and valuable. With the burst of the high tech bubble, however, came rising skepticism among investors concerning the objectivity of some analysts over optimistic recommendations. Many in the media have also asserted that a variety of conflicts of interest may have gradually depreciated analysts' independence during the internet craze and affected the quality of their opinions. We have debated the issues surrounding analysts' independence for many years. After the deregulation of trading commissions in 1975, Wall Street firms began using investment banking as a means to compensate their research departments, and within the last few years the tying of analyst compensation to investment banking activities has become increasingly popular. As competition among brokerage firms for IPO's, mergers and acquisitions grew, so did the potential for large compensation packages for sale-side analysts. These pay practices, however, may have also effected analysts' independence. While some brokerage houses suggest that they have executed an impenetrable Chinese wall that divides analyst research from other firm functions like investment

banking and trading, the truth, as we have learned from many recent news stories, is that they must initiate a proactive effort to rebuild their imaginary walls.

The release of some startling statistics has also called in to question the actual independence of analyst. A report by First Call, for example, found that less than 1% of 28,000 recommendations issued by brokerage analysts during the late 1999's and most of 2000 called for investors to sell stocks in their portfolios. Within the very same time frame, the NASDAQ composite average fell dramatically. In hindsight, these recommendations appear dubious. Furthermore, First Call has determined that the ratio of buy-to-sell recommendations by brokerage analysts rose from 6:1 in the early 1990's to 100:1 in 2000. Many parties have consequently suggested that analysts may have become merely cheerleaders for the investment banking division in their brokerage houses. I agree. To me, it appears we may have obsequious analysts instead of objective analysts.

25. The erosion of analysts' objectivity that Rep. Kanjorski discussed was particularly manifest at ML, which employed several well-known analysts who had substantial influence on Wall Street,

26. Throughout the Class Period ML's ratings, reports, and recommendations regarding the ML Stocks were false and contained misleading statements, designed to artificially

inflate and artificially support the price of the ML Stock. Rather than providing unbiased research and recommendations as publicly advertised and proclaimed, ML acted for its own self interest as an investment banker, participating in deal making and business generating activities in the hope of seeming lucrative investment banking fees and substantial compensation for itself, at the expense of its brokers and customers.

27. Dabit, while employed as a ML Broker, was not aware of the conflicts of interest that lay at the heart of ML's research and analysis department. As a consequence, Dabit held securities and recommended that his clients hold securities in reliance upon the materially false and misleading statements made by ML. Plaintiff, believing in the honesty and integrity of his employer and the ML Stocks' market prices as presented by ML, was damaged as a result of ML's unlawful conduct as described herein and saw his customers abandon him when the value of their portfolios evaporated.

BACKGROUND AND HISTORY OF THE ANALYSTS' PROBLEM

28. ML securities analysts who were employed by ML during the operative times reflected herein published two types of reports which were received by investors. Brokers for institutional investors received lengthy detailed reports while brokers for individuals received very short non-descriptive reports. Plaintiff and, in turn, his clients, relied on the reports and ratings which ML knew were not accurate and not correct.

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29. Historically, ML performed both investment banking and research analysts' functions, but ML allegedly maintained a "Chinese" wall between the two functions to ensure that the analysts' research and recommendations remained "objective" and were not influenced by ML's interest in attracting and retaining investment banking business.

30. In recent years, however, the Chinese wall either crumbled or turned into rice paper, with research analysts directly performing investment banking functions and receiving compensation based on their contributions to generating investment banking business, including underwriting initial public offerings and secondary offerings of equity securities, underwriting debt offerings and performing services in merger and acquisition transactions without disclosing material conflicts of interest to the investing public or ML's Retail Brokers.

31. During 1999 and 2000, ML made materially false and misleading statements designed to encourage Plaintiff and Plaintiff's clients to continue to hold the ML Stocks. The recommendations were based not on objective analysis, but rather on ML's desire to attract and retain investment banking business for ML and to profit ML at the expense of the Brokers and their clients. ML's ratings, recommendations and positive comments regarding various stocks, including ML Stocks in which ML was a market maker during this period of time, were improperly influenced by their desire to increase their revenues and profits and the undisclosed personal compensation of the analysts who were benefiting thereby.

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32. The conflicts of interest for ML's analysts remained undisclosed as they continued to inflate ratings and recommendations for various stocks, including ML Stocks, throughout late 1999 and early 2000. ML knew that the financial condition and future business prospects of the corporations behind these stocks did not support ML's positive comments and buy recommendations, but ML nevertheless continued to issue positive reports encouraging investors, including Plaintiff, to hold the ML Stocks.

33. In some cases, ML simply refused to downgrade its stock recommendations because that would potentially impair ML's ability to generate additional investment banking business that ML wished to underwrite. In some cases, ML officers, affiliates and agents held ML recommended stocks because a downgrade by a ML analyst would materially adversely affect the ML stocks value.

34. ML's efforts were designed to, and did, effect an artificial inflation and artificial price of ML Stocks, while simultaneously attracting and retaining the underlying and new corporations as ML investment banking clients.

35. After the market for internet and technology stocks collapsed in the first quarter of 2000, journalists, academics, and others began to expose the truth about the roles of analysts, including those at ML.

36. The conflicts of interest exhibited by ML analysts also began to draw the attention of various state and federal government authorities. ML did not timely disclose to Plaintiff that regulators were investigating ML's practices as described herein.

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37. During the Class Period, ML continually promoted the ML Stocks in the press, on television and the internet. This publicity campaign was intended to and did assure Plaintiff of ML's alleged integrity and expertise and reached not only investors who were brokerage customers of Plaintiff at ML, but also individual investors, not ML customers.

38. At the height of the internet boom in late 1999 and early 2000, ML analysts were virtually indistinguishable from their investment bankers. This material fact, however, was never disclosed in connection with ML's ratings, recommendations and other statements regarding the stocks ML was pumping up. ML also withheld this fact from Plaintiff.

39. Unlike firms that did not do investment banking business, ML continued to keep or hold buy recommendations and continued to make highly complimentary comments about corporations with whom ML had conducted initial public offerings ("IPO's") and whose stock prices were subsequently being pumped up or supported by ML in the secondary market.

40. When the price of these favored ML Stocks began to fall in the mid 2000's, ML was still not downgrading the stocks but instead continued to tout these ML Stocks as excellent investments for Plaintiff and his clients to continue to hold. Sometimes, at the same time as it was touting it Brokers and clients to hold the ML Stocks, ML and its agents and affiliates were selling their positions.

41. In some cases ML kept stock prices of ML Stocks from subsequently falling by continuing its campaign of false and misleading statements, including maintaining and/or reiterating buy and strong buy recommendations.

42. ML's unlawful conduct allowed it to earn millions of dollars in investment banking fees during this period of time and allowed its analysts to receive millions of dollars in salaries and cash bonuses due to their false and misleading ratings, recommendations and pumped up statements.

43. During the time of the technology rise, ML allowed analysts to personally buy and sell shares of stocks they followed, without ever disclosing such sales to Plaintiff.

44. ML, recognizing the problem it created, and as part of its cover up, finally announced on July 12, 2001, that it would prohibit research analysts from buying stock in the companies they cover. ML did not, however, self disclose the corrupt system it had implemented and fostered prior to that date.

PLAINTIFF'S CLASS ACTION ALLEGATIONS

45. Plaintiff brings this action as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b)(3) on behalf of himself and on behalf of a class (the "Class") of persons who, while employed by ML as Retail Brokers, held individually or on behalf of the Classes' clients, any of the ML Stocks during the period from December 1, 1999 through and including December 31, 2000 (the "Class Period"), and were damaged thereby. Excluded from the Class is the

defendant herein; the directors and officers of ML; any corporation, firm, partnership, trust or other person affiliated with any of the foregoing; and the legal representatives, agents, heirs, successors-in-interest or assigns of any excluded person.

46. The members of the Class are so numerous that joinder of all members is impracticable. The precise number of Class members is unknown to Plaintiff at this time but Class members are believed to number in the thousands.

47. Plaintiff will fairly and adequately represent and protect the interests of the members of the Class. Plaintiff has retained competent counsel experienced in class action litigation to further ensure such protection and intend to prosecute this action vigorously.

48. Plaintiff's claims are typical of the claims of the other members of the Class because Plaintiff and all the Class members' damages arise from and were caused by the same series of deceitful acts undertaken by or chargeable to ML. Plaintiff does not have interests antagonistic to, or in conflict with, the Class.

49. A Class Action is superior to other available methods for the fair and efficient adjudication of this controversy. As the damages suffered by individual class members may be relatively small, the expense and burden of individual litigation may make it virtually impossible for most class members individually to seek redress for the wrongful conduct alleged. Plaintiff knows of no difficulty that will be encountered in the management of this litigation that would preclude its maintenance as a class action.

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50. Common questions of law and fact exist as to all members of the Class and such questions predominate over any questions affecting solely individual members of the Class. Among the questions of law and fact common to the Class are:

(a) Whether the actions by ML constituted breach of fiduciary duty and breach of the duty of good faith and fair dealing;

(b) whether ML participated directly or indirectly in the concerted action or course of conduct complained of herein;

(c) whether ML artificially inflated or artificially supported recommended stocks through manipulative conduct as complained of herein; and

(d) the extent of injuries sustained by members of the Class and the appropriate measure of damages.

51. The names and addresses of class members, or their prior addresses are available from records maintained by ML. Notice can be provided to Class Members by a combination of published notice and first class mail using techniques and forms of notice similar to those customarily used in similar class actions.

Appendix F

CLAIMS FOR RELIEF

COUNT I

Breach of Fiduciary Duty

1. Plaintiff repeats and realleges each and every allegation contained above.

2. A fiduciary relationship existed between ML and Plaintiff and all members of the class because a special competence and confidence was placed in ML who, in equity and good conscience, was bound to act in good faith and with due regard for the interests of Plaintiff and all members of the class.

3. A confidential relationship arose between Ml and Plaintiff and all members of the class by reason of the professional and business relations between those parties as set forth hereinabove.

4. ML breached its fiduciary duties to Plaintiff and all members of the class in the manner described hereinabove.

5. Plaintiff and other members of the Class have been damaged by defendant's violations as described in this Count and seek recovery for the damages caused thereby.

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COUNT II

Breach of The Covenant of Good Faith and Fair Dealing

6. Plaintiff repeats and realleges the allegations set forth above as if set forth fully herein.

7. The wrongful acts alleged herein violated ML's requirement of good faith and fair dealing towards Plaintiff and the class members. ML failed to act in a manner consistent with its representations to the class members or in a manner which a reasonable person would regard as fair and honest or in good faith.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff, on his own behalf and on behalf of the Class, prays for judgment as follows:

A. Declaring this action to be a class action properly maintained pursuant to Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure;

B. Awarding Plaintiff and the other members of the Class damages, including punitive damages, as provided by law;

C. Awarding Plaintiff and other members of the Class their costs and expenses of this litigation, including reasonable attorneys' fees, accountants' fees and experts' fees and other costs and disbursements; and

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D. Awarding Plaintiff and other members of the Class such other and further relief as may be, just and proper under the circumstances.

Signed this 21st day of October, 2002.

JURY TRIAL DEMANDED

Respectfully Submitted,

s/ _____
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-and-

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Appendix F

EXHIBIT A

Company Name	Symbol	Investment Banking Relationship
Aether	***AETH***	***YES***
Ariba	***ARBA***	***YES***
Applied Micro Circuits	***AMCC***	***NO***
Digital Island	***ISLD***	***YES***
Commerce One	***CMRC***	***NO***
Brocade	***BRCD***	***YES***
Broadcom	***BRCM***	***YES***
Barnesandnoble.com	BNBN	YES
CMGI, Inc.	***CMGI***	***NO***
Corio	CRIO	YES
Extreme Networks	EXTR	YES
Exfo Electro-Optical Engineering	EXFO	YES
Global Crossing	GBLXE*	YES
Internet Capital Group	***ICGE***	***YES***
DrKoop.com	KOOP	YES
EToys, Inc	ETYSQ*	YES
Exodus	***EXDS***	***YES***
Globix	***GBIX***	***YES***
Finisar	FNSR	YES
Infospace	INSP	YES
Exfo Electro-Optical Engineering	EXFO	YES
Vitria	***VITR***	***YES***
Doubleclick	***DCLK***	***YES***
Inktomi	***INKT***	***YES***
PMC Sierra	***PMCS***	***NO***

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Company Name	Symbol	Investment Banking Relationship (Cont'd)
Verisign	***VRSN***	***NO***
Akamai Technology	AKAM	YES
Foundry	FDRY	YES
McData	MCDT	YES
Microstrategy	***MSTR***	***YES***
Nextlink Communications	XOXO*	YES
Inrange Technology	INRG	YES
Yahoo!	***YHOO***	***NO***
Amazon.com	***AMZN***	***NO***
Pets.com	*	YES
Priceline.com	PCLN	YES
RealNetworks (Progressive Networks)	***RNWK***	***YES***
TheStreet.com	TSCM	YES
USN Communications	***USNC***	***YES***
Vitria Technology Inc.	***VITR***	***YES***
Webvan Group Inc.	WBVN	YES
JDS Uniphase	***JDSU***	***NO***
I2 Technologies	ITWO	NO
SDLI	***SDLI***	***YES***
Starmedia	STRM	YES
Sycamore	***SCMR***	***YES***
Juniper	***JNPR***	***NO***
Cacheflow Inc.	CFLO	NO

* Indicates company is now ***bankrupt*** and/or has been ***de-listed.***

Companies in bold and italics indicate Shadi Dabit owned company in his own account.

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EXHIBIT B

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

Index No.

IN THE MATTER OF

An Inquiry by ELIOT SPITZER,
Attorney General of the State of New York,

Petitioner,

Pursuant to Article 23-A of the General Business Law of the State of New York with regard to the acts and practices of

Merrill Lynch & Co., Inc., Henry Blodget, Justin Baldauf, Kirsten Campbell, Virginia Syer Genereux, Sofia Ghachem, Thomas Mazzuoco, Edward McCabe and Deepak Raj,

Respondents,

In the offer, sale, issuance, promotion, advertisement, exchange, marketing, distribution and transfer of, or investment advice for, securities in and from the State of New York.

AFFIDAVIT IN SUPPORT OF APPLICATION FOR AN ORDER PURSUANT TO GENERAL BUSINESS LAW SECTION 354

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County of New York)
ss:
State of New York)

Eric R. Dinallo, being duly sworn, deposes and says:

I am the Chief of the Investment Protection Bureau of the New York State Department of Law and am of counsel to Eliot Spitzer, Attorney General of the State of New York. I am familiar with the facts and circumstances of the above-captioned investigation that give rise to the within application. The following statements are made upon information and belief based upon an examination of records and documents in the possession of the New York State Department of Law and testimony taken before the Attorney General's Office. On behalf of Attorney General Eliot Spitzer, I submit this affidavit, together with exhibits, in support of the Attorney General's *ex parte* application for the attached order pursuant to Section 354 of the General Business Law ("GBL").

In June 2001, the Office of the Attorney General commenced an investigation pursuant to GBL Article 23-A (the "Martin Act") into stock recommendations issued by research analysts. The investigation includes recommendations on all stocks covered by the internet research analysts at Merrill Lynch and, very recently, has expanded to include recommendations made by analysts at several additional financial institutions.

The Office of the Attorney General has to date reviewed over 30,000 documents, comprising over 100,000 pages,

including thousands of e-mails. It has examined close to twenty witnesses under oath, and has consulted with other witnesses, their lawyers, and experts. While Merrill Lynch has been cooperative in producing evidence, some of the witnesses examined have displayed an implausible lack of recollection of key conversations and documents, even when they authored or received such document and it was placed before them. This lack of recollection often related to events and documents that one would be unlikely to forget. The credibility of these witnesses is consequently suspect. Thus, further testimony is sought under judicial supervision and with public scrutiny.

The Attorney General, having determined to commence an action pursuant to GBL Article 23-A, seeks this relief pursuant to GBL §354, which provides that the Attorney General may apply for an *ex parte* order to obtain respondents' testimony, books and records when he believes the same to be "material and necessary" to his investigation of their activities in the offer, sale, and purchase of securities, and investment advice for such securities, within and from the State of New York. GBL §354 further provides that the Supreme Court shall grant such application as a matter of course, along with a preliminary injunction or stay, as is "proper and expedient."

The public testimony, books and records of respondents in this proceeding are material and necessary to the investigation being conducted by the Attorney General. Further, as detailed below, information has come to the attention of the Attorney General that establishes the need for immediate equitable intervention by this Court to prevent

further fraud, to protect the rights of the investing public, and to educate it about the enclosed material pending completion of the Attorney General's investigation into Merrill Lynch and other financial institutions.

I. INTRODUCTION

Since late 1999, the internet research analysts (the "internet group") at Merrill Lynch have published on a regular basis ratings for internet stocks that were misleading because: (1) the ratings in many cases did not reflect the analysts' true opinions of the companies; (2) as a matter of undisclosed, internal policy, no "reduce" or "sell" recommendations were issued, thereby converting a published five-point rating scale into a *de facto* three-point system; and (3) Merrill Lynch failed to disclose to the public that Merrill Lynch's ratings were tarnished by an undisclosed conflict of interest: the research analysts were acting as quasi-investment bankers for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purpose of attracting and keeping investment banking clients, thereby producing misleading ratings that were neither objective nor independent, as they purported to be.

Behind these ratings was a serious breakdown of the separation between the Merrill Lynch banking and research departments, a separation that was critical to the integrity of the recommendations issued to the public by Merrill Lynch. Though Merrill Lynch's stated policies reflect an understanding that this separation is critical, the evidence reveals that at least with respect to the internet group, there was insufficient divide between research and banking.

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Our investigation to date reveals that the compensation system for internet analysts was a significant factor contributing to the breakdown between the internet group and investment banking departments. Research analysts knew that the investment banking business they generated or participated in would impact their compensation, and management encouraged them to produce investment banking business. Analysts curried favor with potential or actual investment banking clients by giving them special treatment. At times, officers of clients or prospective clients were allowed to redraft their own coverage, write quotations in which the analysts would tout their companies, and indicate which ratings would be acceptable to them.

The pressures put on the Merrill Lynch internet group to appease both investment bankers and clients led the group to ignore the bottom two categories of the five-point rating system ('reduce" and "sell") and to use only the remaining rating ("buy", "accumulate" and "neutral"). The absence of clear guidance from Merrill Lynch management on how to resolve the conflicts created by these pressures led respondent Henry Blodget, the head of the internet group, in a moment of candor, to threaten to "*start* calling the stocks (stocks, not companies) . . . like we see them, no matter what the ancillary business consequences are." (ML 68401) (emphasis added).[1]

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1. Submitted herewith is a volume of exhibits reflecting the following categories: "ML" refers to documents produced to the Attorney General's Office by Merrill Lynch; "OV" refers to documents produced by Overture Services, Inc.; "KC" refers to documents produced by Kirsten Campbell. "Tr." refers to transcript of testimony taken by the Attorney General's Office; "Exhibit" refers to documents introduced at testinony taken by the Attorney General's Office.

Based upon the foregoing and as explained below, the Attorney General seeks relief as described in the annexed proposed order.

II. PARTIES

The petitioner, Eliot Spitzer, is Attorney General of the State of New York. Pursuant to Article 23-A of the General Business Law, the Attorney General oversees the offer, sale, issuance, promotion, advertisement, exchange, marketing, distribution and transfer of, or investment advice for, securities within and from the State of New York, and has authority to seek judicial intervention when fraudulent activities have occurred or are about to occur. The Attorney General's principal office for oversight of the securities industry in New York State is located in New York County.

Respondent Merrill Lynch & Co. Inc. ("Merrill Lynch") is an international investment firm that provides investment banking services to businesses, engages in retail and institutional sales to its customers, and publishes research reports and ratings on stocks. Merrill Lynch's corporate headquarters are located in New York City.

Respondent Henry Blodget ("Blodget") was, until his departure from Merrill Lynch in December 2001, a managing director and head of the Internet Research group in New York City. Mr. Blodget reported to respondent Deepak Raj and Andrew Melnick.

Respondent Justin Baldauf ("Baldauf") is an analyst in the Internet Research group at Merrill Lynch in New York

City. Mr. Baldauf reported to respondent Blodget, and became head of the Internet Research group upon Mr. Blodget's departure from Merrill Lynch.

Respondent Kirsten Campbell ("Campbell") was, until her departure from Merrill Lynch in April 2001, a vice-president and analyst in the Internet Research group in New York City. Ms. Campbell reported to respondent Blodget.

Respondent Virginia Syer Genereux ("Syer") is a research analyst at Merrill Lynch in New York City. Ms. Syer reported to respondent Blodget.

Respondent Sofia Ghachem was an analyst in the Internet Research group at Merrill Lynch in New York City. Ms. Ghachem reported to respondent Blodget.

Respondent Thomas Mazzucco ("Mazzucco") is a managing director of Merrill Lynch's Investment Banking Technology group in Palo Alto, California.

Respondent Edward McCabe ("McCabe") was, until his departure from Merrill Lynch in December 2001, a first vice president and a senior analyst in the Internet Research group in New York City. Mr. McCabe reported to respondent Blodget.

Respondent Deepak Raj ("Raj") is head of Global Equity Research at Merrill Lynch in New York City.

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III. STATUTORY FRAMEWORK

Article 23-A of the General Business Law ("GBL") of the State of New York, commonly referred to as the "Martin Act," and the regulations issued pursuant thereto regulate the offer and sale of securities within and from the State of New York and authorize the Attorney General to investigate the conduct of persons and entities engaged in, *inter alia*, the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within or from the State of New York of any securities.

The Martin Act proscribes a wide array of practices in connection with the sale of securities. It prohibits and makes illegal any fraud, misrepresentation, deception, concealment, promise or representation that is beyond reasonable expectation while engaged in the issuance, distribution, investment advice, sale or purchase of securities within and from the State of New York. The statutory scheme also prohibits and makes illegal any artifice, device or scheme to obtain money by any means prohibited by General Business Law §352-c. Unlike the federal securities laws, no purchase or sale of stock is required, nor are intent, reliance, or damages required elements of a violation.

GBL Section 352 (1) defines fraud and fraudulent practices as including, *inter alia*, any device, scheme or artifice to defraud or obtain money by means of any false pretense, representation or promise, fictitious or pretended purchase or sale, and any concealment, suppression, fraud, false pretense or false promise in connection with the sale of securities or offering of investment advice. It also provides,

inter alia, that violation of any section of GBL Article 23-A is a fraudulent practice, and authorizes the Attorney General to investigate allegations of fraud.

When, based upon a preliminary investigation, the Attorney General determines to commence an action pursuant to Article 23-A, he may seek an *ex parte* application from the Supreme Court, pursuant to GBL §354, for an order directing the persons and entities mentioned in the application to appear and answer questions and to produce documents that the Attorney General believes to be material and necessary. In addition, the Attorney General may include with such application a request for a preliminary injunction or stay as maybe "proper and expedient." At the conclusion of the investigation, the Attorney General is empowered, under GBL §353, to seek an injunction permanently enjoining an individual or entity from directly or indirectly engaging in the issue, sale or offer of, or investment advice for, securities within or from the State of New York, as well as restitution, and/or, under GBL §352-c. to file criminal charges against such individuals or entity.

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IV. FACTS

A. *The Internet Group's Stock Ratings Were Misleading*

1. The Merrill Lynch Rating System: Theory Versus Reality

Until June 15, 2001, Merrill Lynch had a five-category stock rating system:

1 Buy (20% or more price growth expected)
2 Accumulate (10% to 20% price growth expected)
3 Neutral (10% price growth to 10% price drop expected of price)
4 Reduce (10% to 20% price drop expected)
5 Sell (20% or more price drop expected)

(ML 02084-85).

Each covered stock was rated for both the intermediate-term (through the next twelve months) and long-term (beyond twelve months), and assigned an investment risk ranging from "A" (least risky) through "D" (most risky).[2] The ratings assigned to covered companies were represented to the investing public to be independent, objective and on the merits:

Objectivity of Opinions. Opinions expressed by Analysts must be objective. Any indication that a

2. All of the stocks discussed herein were assigned a "D" rating by the Merrill Lynch Internet group.

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> Research opinion is less than totally objective, or that it may have been influenced by a business relationship of the Firm, could seriously damage the Firm's reputation and lead to potential legal liability.

(ML 02063; *see also* ML 85893). Our investigation indicates that this was not the case with respect to ratings published by the Internet group.

Although Merrill Lynch's published rating system provided for 4s (reduce) and 5s (sell), the internet group never used 4s or 5s. The list of covered internet stocks for the second quarter of 2000, for instance, lists 24 stocks, none of which was rated less favorably than a 2. (ML 03747). From the spring of 1999 to the fall of 2001, Merrill Lynch never published a single reduce or sell rating on any stock covered by the Internet group. In their sworn testimony, both Blodget and his subordinate, respondent Kirsten Campbell, confirmed that the group never rated a stock 4 or 5. (Blodget Tr. at 115-19; Campbell Tr. at 36). Thus, although represented to be a five-point system, internally it became a three-point system. In lieu of assigning reduce or sell recommendations to stocks they no longer favored, the internet group instead merely quietly stopped covering the stock, without any announcement or meaningful explanation to the retail public. (ML 87610).

Thus, as previously covered stocks such as Pets.com, Mypoints.com. Quokka Sports, Webvan, iVillage, Buy.com. 24/7 Media, E-Toys, Internet Capital Group, and InfoSpace plummeted, sometimes all the way to zero, retail customers

and the investing public were never advised to sell. (ML 51690, ML 51833, ML 51997, ML 52195, ML 52516, ML 53160, ML 53161, ML 53162, ML 53181, ML 53507, ML 53612 and ML 53760; *see also* ML 87610). The reason for this failure is at least in part the substantial unrevealed conflict of interest discussed below.

2. The Ratings Assigned to Stocks Did Not Comport With Their Definitions

Although perhaps comforting to investment banking clients (who could be assured their stocks would never get a reduce or sell rating because "we don't cover anything below a 3" (OV 00276)), the de facto three-point system not surprisingly wreaked havoc amongst the various constituencies called upon to interpret and utilize the ratings, especially the retail public. While sophisticated institutional investors and equities traders may have recognized the de facto three-point scale, *see* (ML 55256-58) ("3-1 is a major red flag - short"), or may have specifically been told by the Internet group that, despite a stock's 3-1 rating there was nothing "interesting" about a company "except the [investment] banking fees" (ML 03806), the public and retail investors did not have such insight.

Thus, the public was unaware that while the Internet group was contemplating a 3 (neutral) rating on selected stocks, internally they were saying amongst themselves that the stock was "going a lot lower," (ML 09045), that the company was "crap," (ML 51453, 37899), or a "dog" (ML 37700). Nor was the public told that while the Internet group was contemplating a 2 (accumulate) rating on a variety of

stocks, internally — and to selected institutional investors — the analysts were saying that there was "(no) reason to buy more of" the stock and its business was "falling apart," (ML 74038), "[n]o reason to own" the stock, (ML 09045), or that the group expected the stock to be "flat" over the next six months without "any real catalysts [for change]" (ML 37956). The public also was not told that the group internally disparaged other stocks rated 2 as a "piece of shit," (ML 60903, 64372), and "such a piece of crap." (ML 51453).

The electronic communications of the Internet group feature many such exchanges. For example, on August 30, 1999, the group initiated coverage on the stock of Internet Capital Group (ICGE), an investment banking client, with a 2-1 rating. The stock closed on October 4, 2000 at $15.69, down from a high of $212 on December 22, 1999. On October 5, 2000 with the stock at $12.38, in an e-mail exchange with another senior analyst, Blodget predicted the stock was, "going to 5." (ML 63900). The next day he wrote in an e-mail: "No helpful news to relate [regarding ICGE], I'm afraid. This has been a disaster . . . there really is no floor to the stock." (ML 63901). But even with these prognostications, the public rating remained 2-1 and, when eventually downgraded on November 9, 2000, was changed only to a 2-2. The result was a continued recommendation to the investing public to purchase a stock about which the head of the Internet group was obviously exceptionally and accurately pessimistic, and for which he anticipated a drop of an additional 60 percent. (ML 63900-01; ML 64077; ML 53507). Despite this pessimistic outlook, ICGE was on Merrill Lynch's list of the top ten technology stocks ("Top Ten Tech" list), as late as September 12, 2000. (ML 62490-01).

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Under this regime, even a 1-1, Merrill Lynch's highest investment rating, could not be trusted. In one example, while a company's stock price was $96.50, the analysts, while reviewing a research note reiterating the 1-1 rating, wrote of the stock's prospects: "could go very low," "could hit $50 or $60 I think." (ML 63652).

Merrill Lynch maintained a list of its highest recommended stocks, selected from all of the stocks Merrill Lynch covered — not just internet stocks. To be selected for this list (the "Favored 15"), to which retail brokers and the public had access, a stock had to have a 1-1 rating. (ML 09639). InfoSpace was on the "Favored 15" List from at least August 2000 until December 5, 2000, even though Blodget had acknowledged as early as July 2000 that the stock was a "powder keg" and that "many institutions" had raised "bad smell comments" about it, and in October had referred to it as a "piece of junk." (ML 06413-14, ML06578) Oddly enough, Blodget was unaware that the stock he had been covering for months carried the imprimatur of the "Favored 15." (ML 61728, ML 61784-85). When a broker eventually complained on October 20, 2000, about Blodget's price objective and rating of the stock, Blodget contacted a fellow analyst: "[c]an we please reset this stupid price target and rip this piece of junk off whatever list it's on. If you have to downgrade it, downgrade it." (ML 06578). InfoSpace however, was not removed from the "Favored 15" until December 5, 2000 (ML 06700) and was not downgraded until December 11, 2000. (ML 00388; *see also* ML 61784-85)

Below is a chart of examples demonstrating discrepancies between the numerical investment ratings assigned by the Internet group and the group's contemporaneous internal analysis or opinions.

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3. Merrill Lynch Did Not Disclose The Analysts' Critical Conflicts of Interest

(a) The Internet Research group was not independent of investment banking

The evidence establishes that the Internet Research analysts were far from independent of their investment banking colleagues, and that their tortured relationship helped drive both the selection of covered stocks and the ratings ultimately assigned.

Tension between the various departments in a single firm is nothing new. At a securities firm, this tension is usually addressed by the establishment of a "Chinese Wall" – an internal relationship barrier by which investment bankers are prevented from sharing with other firm employees material, non-public information received by the bankers from their publicly-traded company clients. Thus, a banker generally should be barred from discussing such inside information with a research analyst who is disseminating to the public a research report on the same company. Another form of "Chinese Wall" attempts to prevent investment bankers from influencing analysts' ratings for the stock of existing or potential investment banking clients.

The compensation structure of a securities firm can exacerbate the potential for an analyst to be conflicted. Where analysts' compensation is affected, directly or indirectly, by the analysts' contribution to investment banking, analysts' objectivity and independence can be seriously eroded.

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Merrill Lynch's Policies and Procedures Manual for the Research Department (ML 02039, 02049) does not address the conflict raised by the compensation issue. Indeed, research analysts at Merrill Lynch were actively involved in evaluating and effectuating investment banking transactions. Moreover, analysts' compensation was tied to the success of their efforts in this regard.

The analysts in the internet group at Merrill Lynch knew very well that investment banking business translated into compensation for them personally and the firm generally, and that their research played a role in attracting and keeping that investment banking business. (ML 29830, ML 03806, ML 09544-51). In one revealing e-mail exchange, an analyst and investment banker discussed how to attract investment banking business of a company from a competitor. The banker proposed a formula that had apparently worked in the past with another banking client: "we should aggressively link coverage with banking - that is what we did with *Go2Net* (Henry [Blodget] was involved). . . . [I]f you are very bullish (b/c they will love you), they are not happy with GS [Goldman Sachs] and are going to be active, we can probably get by on a 'handshake.'" (ML 05229-30). This e-mail lays bare the understanding that Merrill Lynch intended the prospect of affirmative research to attract investment banking clients.

One way Blodget "prioritize[d]" research coverage for stocks was whether the company had an investment banking relationship with Merrill Lynch. (Blodget, Tr. at 207-08). Consistent with this agenda, Blodget, within weeks of joining Merrill Lynch as head of the Internet Research group,

distributed a memorandum entitled, "Managing the Banking Calendar for Internet Research," which he sent to the Co-Heads of U.S. Equity Research, and senior investment bankers. The memorandum unapologetically described Blodget's expectation that at least 50 percent of his and his team's time would be allocated to investment banking matters. In addition to discussing, "banking transactions [] in the pipeline" and "promising deals," the memorandum described Blodget's work schedule for one week as being divided "85% banking, 15% research." (ML 34660-61). Blodget's own time allocation reveals that Merrill Lynch viewed research as a sales tool for investment banking.

From December 1999 to November 2000, the Internet group was involved in investment banking deals that — on its own estimate — produced approximately $115 million of revenue to Merrill Lynch. The list of the group's activities for that year included participating in the bankers' sales pitch to potential clients; marketing transactions to institutional investors once the bankers had obtained the assignment; and then initiating and doing "follow-on" research coverage. This list is eight single-spaced pages long and contains scores of banking deals. (ML 09544-51, Campbell Tr. at 73-83).

The evidence examined to date confirms that the analysts' decisions about whether a stock should get coverage and what type of coverage it should receive were made neither objectively nor independent of the investment banking group. In one instance, an analyst stated that "part of the reason we didn't highlight [a risk] is because we wanted to protect ICG's banking business." (ML 60807). In another communication, an analyst worried about the impact of a particular rating on

the relationship with investment banking or its venture capitalists. (ML 60725). So pervasive was the tie between investment banking and research coverage, that when a competitor unexpectedly initiated coverage on the stock of a potential investment banking client, it prompted one Merrill Lynch analyst to respond, "they are angling for the M&A business too!" (ML 09032).

Analysts conveyed to one another that they would "win brownie points" from investment banking if the investment bankers could assure a company that the analysts would cover its stock. (ML 99103). Implicit in this was that "coverage" would always be favorable. Bankers, in turn, attempted to use the analysts to move the price of a stock to a level where research could be initiated, and so fulfill the promise of research coverage in exchange for banking work. One banker, who was frustrated by a stock's failure to reach the requisite price level of $10 before coverage could commence,[3] implored the Internet group to let the company speak at the group's upcoming conference that would be attended by many institutional investors — to promote Merrill Lynch's "active banking agenda" with the company and alleviate the company's unhappiness with the "research tie up" at Merrill Lynch. (ML29750).

Investment banking also was involved in criticizing and editing the Internet group's reports for client companies, opining on whether a particular rating would be acceptable

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3. Pursuant to a consent decree entered into with the Securities and Exchange Commission in the 1970's, Merrill Lynch is prohibited from initiating coverage on stocks trading below $10. (Abbott, Tr. at 84-85; ML 09151.) *See also* ML 02053.

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Company	Date	Contemporaneous Analyst Comments	Published Rating
Aether System (AETH)	03/15/01	"might have announcement next week . . . which could pop stock . . . but fundamentals horrible" (ML82578)	3-1
Excite @home (ATHM)	12/27/99 12/29/99	"we are neutral on the stock" Six month outlook is "flat", without any "real catalysts" for improvement seen (ML 37899; ML37956)	2-1
Excite @home (ATHM)	06/03/00	"such a piece of crap" (MLS 1453)	2-1
GoTo.Com (GOTO)	1/11/01	Nothing interesting about company "except banking fees" (ML03806)	3-1
InfoSpace (INSP)	7/13/00	"this stock is a powder keg, given how aggressive we were on it earlier this year and given the "bad smell" comments that so many institutions are bringing up (ML06413)	1-1

Company	Date	Contemporaneous Analyst Comments	Published Rating
InfoSpace (INSP)	10/20/00	"piece of junk" (ML06578)	1-1
Internet Capital Group Inc. (ICGE)	10/05/00	"Going to 5" (closed at $12.38) (ML63901)	2-1
Internet Capital Group Inc.(ICGE)	10/06/00	"No hopeful news to relate. . . . We see nothing that will turn this around near-term. The company needs to restructure its operations and raise additional cash, and until it does that, there is nothing positive to say." (ML64077)	2-1
Lifeminders (LFMN)	12/04/00	"POS" (piece of shit) (ML60903)	2-1
24/7 Media (TFSM)	10/10/00	"piece of shit" (ML 64372)	2-2

and, in at least one instance, apparently opposing a proposed rating because "[there is no] interest in seeing initiation [of research coverage] at a 3-2 [rating]." (ML 03799). Analysts openly discussed the conflict in e-mails, stating "the whole idea that we are independent front banking is a big lie — without banking this would be [rated] a 3-2." (ML 09045).

Research management itself acknowledged that "we are off base on how we rate stocks and how much we bend backwards to accommodate banking etc." (ML 64239). A host of e-mails demonstrate research management's knowledge and understanding of the conflicts, pressures, and confusion. *See, e.g.*, (ML 66935, ML 60847, ML 60865-66, ML 03607-08, ML 87610).

The conflicts and pressures that the research group experienced became particularly acute at the end of 2000 with respect to the mobile internist company, Aether Systems ("AETH"). As of September 27, 2000, Merrill Lynch was doing a secondary equity offering for the company, and the internet group was involved. (ML 09546). During what was supposed to be a confidential telephone conversation about the mobile internet sector, Merrill Lynch research analyst respondent Virginia Syer discussed Aether, InfoSpace ("INSP") and Phone.com ("PHCM"), but chose Phone.com — on which Merrill Lynch then had no coverage and to which it then provided no banking services — as having the "the best real business opportunity." (ML 63333-35, ML 09544-51). When the comments were e-mailed to a large number of recipients, Blodget chastised Eric Wellmann of Merrill Lynch's London office for "blast[ing] the contents out to the whole sales force". (ML 63333-35). Syer concurred, "it could

impair our relations w/those companies we do cover. We are marketing a big secondary for AETH [], and we were [banking] advisor in its sale to INSP. This is the sort of email that gets forwarded by a salesperson, and could very well get [] sent directly to any of these companies." The internet group's desire that accurate assessments be distributed to the public was clearly subservient to the desire to maintain investment banking's relationship with Aether.

Two months later, with Merrill Lynch fresh off the secondary offering of Aether, Syer drafted a downgrade of stocks in the mobile internet sector she covered, which included Aether, InfoSpace and Openwave ("OPWV"), from 1-1s to 2-1s, and forwarded the draft to research management, saying, "I want to be sure I am doing what research management wants here." She described four choices in handling the sensitive downgrade:

> First, we can downgrade to 2-1, and go out with the [draft] below. . . . Second, we can keep Aether at 1-1 . . . and downgrade OPWV and INSP for the reasons cited. (People would invariable [sic] ask the question why aren't we downgrading Aether.) Third, we can downgrade OPWV and INSP and say nothing about Aether. Fourth, we can keep them all at 1-1s and write press releases for research. (I sound flip but I am not being so — If banking is our top concern I'd just like us all to agree on it.)

(ML 06688).

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Andrew Melnick, a then head of Global Equity Research at Merrill Lynch, responded, "THE ONE CHOICE WE CANNOT DO IS DOWNGRADE THE OTHER COMPANIES AND LEAVE AETHER A 1-1. WE ARE NOT IN THE BUSINESS OF WRITING PRESS RELEASES." (ML 06688) (capital letters in original).

But Merrill Lynch did downgrade the others and left Aether at 1-1. On December 11, 2000, InfoSpace and Openwave were each downgraded to a 2-1. (ML 00384-87); Bloomberg News December 11, 2000 ("Openwave Systems cut to near-term 'accumulate' at Merrill") (ML 53507). Aether was not downgraded until February.

The Aether situation culminated in a general indictment by Blodget of the internet group's ratings. At the end of 2000, Blodget threatened to start to rate the stocks honestly, no matter what the investment banking consequences were. His ultimatum was prompted by a long-time broker who felt burned by late downgrades of covered stocks. (ML 68401-02), and an e-mail from research management regarding downgrades. Blodget wrote:

> The more I read of these, the less willing I am to cut companies any slack, regardless of predictable tamper-tantrums, threats, and/or relationship damage that are likely to follow.
>
> If you believe that this stance is a bad business decision for Merrill Lynch, please raise this with [senior management]. We all had to spend (waste) an unbelievable amount of time on the latest

> situation. . . . If there are no new email forthcoming from Andy [Melnick] on how the instructions below should be applied to sensitive banking clients/relations, *we are going to just start calling the stocks (stocks, not companies), including AETH, like we see them, no matter what the ancillary business consequences are.*

(ML 68401-02) (emphasis added). Thus, by Blodget's own admission, as late as the end of 2000, the internet group was *not* calling stocks as they saw them, but was permitting ancillary business consequences to taint their coverage.

Merrill Lynch has never publicly acknowledged the improper influence of investment banking on research. To the contrary, the public was specifically told that the internet group analysts were independent, objective and unbiased. (ML 85893; *see also* ML 02039, 02063). Knowing that such conflicts existed, and that members of the research group routinely acted as quasi-investment bankers, Merrill Lynch pretended there was a clear division, thereby enhancing the analysts' credibility. Thus, prior to the head of the Internet group appearing on television, he was reminded,

> CNN called and wanted to know if we are in AOL deal as an advisor. Head of media relations gave them a no comment. *If you are asked on Moneyline interview about that say something to the effect that you are not in the loop on that as you are in research not banking.*

(ML 41152) (emphasis added).

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(b) The analysts' compensation was linked to their investment banking work

The research analysts' objectivity and independence was further eroded by the fact that their compensation depended in part on their efforts on behalf of investment banking, as demonstrated by the following Fall 2000 request from respondent Deepak Raj, then co-head of global equity research, to all equity analysts:

> We are once again surveying your contributions to investment banking during the year. . . . Please provide complete details on your involvement in the transaction, paying particular attention the degree that your research coverage played a role in origination, execution and follow-up. Please note, as well, your involvement in advisory work on mergers or acquisitions, *especially where your coverage played a role in securing the assignment* and your follow-up marketing to clients. Please indicate *where your research coverage was pivotal in securing participation in high yield offering.*

On November 2, 2000, Blodget and the Internet Research group responded to the above request. In a detailed memorandum with schedules, entitled "IBK Contributions: Internet Team." Blodget stated that: (a) his group had been involved in over 52 completed or potential investment banking transactions; (b) the completed transactions had earned $115 million for the firm; and (c) more transactions would have been completed had not the "market window for most internet companies closed in June." He also identified

the services his analysts typically performed for investment banking, including pitching the client, marketing the offering and, notably, initiation and follow-on research coverage. (ML 09544-51; *see also* ML 33856). Shortly after documenting these contributions, Blodget's salary contract — which contained a guaranteed minimum — was cancelled and replaced with a substantially larger compensation package. Overall, Blodget's agreed-annual compensation, including "guaranteed" minimum cash bonus, increased from $3 million for 1999 to $12 million for 2001.

(c) The analysts were not independent from the companies they covered

The Internet group at times appeared more concerned with acting as consultants to the companies they covered than as objective analysts. For example, as the stock of InfoSpace plummeted, losing almost 90 percent of its value in a year, the Internet group counseled a senior officer of the company on how to handle himself and whether certain decisions were good business moves. (ML 06028). When the company's officer confided a plan to invest in a particular venture, the analyst gave investment banking advice:

> We need to talk about this. While I understand your genuine enthusiasm for the company and trust your "killer deal instinct", I am concerned that the market will not react favorable to any news that [InfoSpace] fund US Search. My BEST advice to you is to let Yahoo and Lycos win this one — there will be plenty of deals for you to do

> and [InfoSpace] cannot afford this kind of scrutiny right now — the stock is under a lot of pressure.

(ML 06424). Thus, as Merrill Lynch was supposedly providing the public with its objective opinion about a company's stock, it did not reveal that it was simultaneously advising that company how to keep the stock stable.

Merrill Lynch did not disclose to the public that the Internet group shared — and at times appeared even to negotiate — proposed ratings with the bankers and companies at issue, in clear violation of Merrill Lynch policy that analysts "may not disclose proposed investment conclusions" to company management. (ML 02054). Indeed, Blodget claimed not to even know of this prohibition. (KC 013). The results are intensely problematic: in one instance, a company agreed to a particular rating under the condition that its main competitor's stock would be downgraded to that same rating. It clearly violates Merrill Lynch's internal policies and illustrates that the subsequent ratings were biased when a company is given advance notice of its stock rating and a voice in a competitor's downgrade. (ML 09061). In another e-mail, an analyst reported that management of a company "do[es] not feel comfortable with us launching coverage of their stock . . . until [we] . . . [can] come out w[ith] a buy rating." (ML 63362). The internet group even contemplated giving coverage to a stock simply as an "accommodation for an important client," but only for six months, after which coverage would be dropped. (ML 36662).

The undisclosed influences manifested themselves in "support" for selected stocks. In one striking instance, an

internet analyst drafted a report on a company and shared it with Blodget, stating "trying to be oblique to help stock in anticipation of downgrade on wed[nesday]." (ML 43008). By failing to disclose the Internet group's candid appraisal of the stock's immediate prospects, Merrill Lynch deprived the public of necessary information. The deception inherent in the Internet group's ratings are the group's concerns for how their ratings and coverage would "impact . . . on the stock if we do a 3-1 so am leaning towards a 2-2 which is still our lowest rating," (ML 60723), or how they "may piss off" company management by writing what they really thought. (ML 63399).

(d) Misleading information was widely disseminated

The investment ratings of research were continuously made available to Financial Consultants — retail brokers — through Merrill Lynch's QRQ Opinion System. The system was designed to provide immediate access to the ratings by means of the broker's quote terminal; the information was also available in hard copy. When the retail broker pulled up a particular stock on the quote terminal, it showed the investment ratings, the stock price, any changes to the price and certain historical data such as price range, price/earnings ratio, and dividend. While other information about a company may have been available to the broker, such as flash notes and the research report, the broker was not required to consult it. Research Department's Policies and Procedures Manual, (ML 02052; ML 02083; Raj, Tr. at 164-89).

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Analysts also discussed recent research reports during a morning call apparently held before the market opened. Participation in the morning call was available to the Merrill Lynch institutional and retail sales forces. (Abbott, Tr. at 126-29). Research reports were also released on Merrill Lynch on-line system(s), which were available to Merrill Lynch clients and to third party vendors such as Bloomberg and First Call who made the reports available to subscribers who were entitled by Merrill Lynch to receive them. After a report had been released, institutional and retail clients and brokers who requested particular reports and had been "sponsored" (*i.e.*, a sales person or analyst paid the distribution cost) were e-mailed or mailed that particular report. *Id.*

Finally, research analysts discussed their opinions of stocks on appearances televised to the general investing public. For instance, in 1999 and 2000, Blodget appeared on television at least 77 and 46 times, respectively, often on CNBC and CNN. (March 4, 2002 letter of Andrew Kandell, Esq., Merrill Lynch, to Eric Dinallo, Esq., New York State Attorney General's Office).

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B. *Two Troubling Examples of Merrill Lynch's Treatment of Two Stocks*

1. GOTO.COM

a. Initiation of GoTo Coverage Was Linked to Banking Business

GoTo.com ("GoTo") (now known as Overture Services, Inc.) was an internet company, from which Merrill Lynch attempted and failed to obtain investment banking business in connection with its initial public offering ("IPO") in 1999. In 2000, Merrill Lynch again sought investment banking business from GoTo, in the form of a private placement offering for a European subsidiary of GoTo. The "pitch book" not only touted investment banking at Merrill Lynch but also heavily promoted Merrill Lynch's research analysts, including Blodget and his Internet group. (ML 17656-17657; ML 17709; ML 09279-80). By early September 2000, Merrill Lynch had received the mandate (*i.e.*, assignment) from GoTo for the European private placement, with the fee mostly contingent upon the private placement closing. (Mazzucco, Tr. at 325-26).

In connection with Merrill Lynch's obtaining this investment banking business, respondent Thomas Mazzucco, on behalf of Merrill Lynch investment banking, committed to Todd Tappin, Chief Financial Officer of GoTo, that Blodget would initiate research coverage of GoTo. (Tappan, Tr. at 100-03; OV 01102). When, in January 2001, Merrill Lynch initiated coverage of GoTo, an institutional investor e-mailed Blodget asking, "What's so interesting about GOTO except

banking fees????" Blodget responded, "nothin." (ML 03806). Blodget's candid response was not included in the initiation report, nor did the report disclose that Merrill Lynch had promised research coverage in exchange for GoTo's investment banking business.

b. The Initiation Process and Rating For GoTo Were Seriously Flawed

Shortly after Merrill Lynch received GoTo's mandate for the European private placement, Kirsten Campbell began working on a research report for initiation of coverage of GoTo. (Campbell, Tr. at 51, 57-61). In mid-September, she e-mailed GoTo financial models and a draft initiation report containing Merrill Lynch's proposed stock rating. Both the models and the draft report contained estimates and opinions, including Merrill Lynch's projections of GoTo's future financial performance. She specifically solicited the company's comments on the drafts and the company apparently provided them. (OV 270; OV 275).

As investment banking pressed for this co-operative drafting, (ML 30009-10), the internet group's objectivity and independence continued to be undermined. Campbell again e-mailed GoTo draft ratings, estimates and opinions in November, and again asked for comments which GoTo provided — including GoTo actually typing its changes into the draft initiation report, or in some sections, supplying the full text (OV 00182; OV 00248; OV 00257; OV 00295; OV 00301-02).

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In December, Campbell e-mailed a new financial model to GoTo, because she wanted it to "know we are cutting [GoTo's] revenue a lot," which would defer projected profitability out to the first quarter of 2003. (OV 01197). Russell Benaroya, GoTo's head of corporate development, e-mailed to Tappin and another colleague:

> "Based on these numbers, why would they even want to initiate on us. Todd [Tappin] should call back and pose that question. This is ridiculous and totally frustrating. Merrill will never take my company public."

(OV 01197). GoTo called Campbell and got its way: the final published initiation research report had profitability occurring sometime in 2002 rather than in the first quarter of 2003. (Tappin, Tr. at 127-29; ML 00404-08).

Disturbing discussions about the ratings were also occurring within Merrill Lynch. On November 16th Campbell e-mailed Blodget that she did not "want to be a whore for f-ing management" and initiate at a 2-2 (accumulate/accumulate) rating:

> if 2-2 means that we are putting half of merrill retail into this stock because they are out accumulating it then i don't think that's the right thing to do. We are losing people money and i don't like it. john and mary smith are losing their retirement because we don't want todd [Tappin, GoTo CFO] to be mad at us.

(ML 09045).

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Campbell also described in part her conversation with Mazzucco about a 3-2 (neutral/accumulate) initiation rating for GoTo. Although, according to Campbell, Mazzucco said he was "fine" with a 3-2, and that banking and research were independent of each other, Campbell responded:

> . . . the whole idea that we are independent from banking is a big lie — without banking this would be 3-2. . . .

Id.

In his sworn testimony, Blodget conceded that the Merrill Lynch investment bankers had veto power over his initiating coverage of GoTo with a 3 rating. (Blodget, Tr. at 211-12). Although apparently agreeing to the neutral intermediate rating, investment banking prevailed in that the rating would be a 3-1 (neutral-buy) and not the 3-2 (neutral-accumulate) that Campbell said would be appropriate but for investment banking's pressure. Hence, on November 21st, Campbell e-mailed Blodget:

> *goto* has gotten back to me and says they are "comfortable" with the discussions we've had with them, and with coming out at a 3-1 etc. given that we would be downgrading LOOK [GoTo's business competitor] at the same time so the ratings are the same . . .

(ML 09061). In the same e-mail, Campbell also informed Blodget that she had consulted with their research colleague, respondent Justin Baldauf, who covered Looksmart, and that

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Baldauf was not convinced that downgrading Looksmart was a good idea because there was "no reason to do now versus before." *Id.*

Although the plan to downgrade Looksmart made Merrill Lynch's proposed 3-1 initiation rating on GoTo sufficiently palatable to GoTo. GoTo's Benaroya expressed concern that a *simultaneous* Looksmart downgrade might attract unwanted attention:

> I don't know if we have to have simultaneous GoTo/Look notes. Wouldn't that be a bit strange? You could probably initiate on GoTo first and come out with a LOOK note soon thereafter. Let me know.

(ML 35973-74). Campbell's response was "re: LOOK – no it wouldn't be strange." *Id.*

Blodget, in an e-mail to Baldauf, confirmed his intention to simultaneously initiation GoTo and downgrade Looksmart "we are going to cut numbers for q1 and q2 and roll with a 3-1 on GoTo, would like to do the same for LOOK if it makes sense. . . ." (ML 09145). Blodget further confirmed the plan on December 19, 2000, when he e-mailed Campbell and Baldauf:

> K,
> Here's the GoTo note.
> Justin, We're planning to roll on this thing on Thursday at 3-1. I'd like to take the LOOK rating to 3-1 at the same time, just so we can keep them

> together. Probably easiest if we just cut the numbers a bit again to be conservative. Let me know your thoughts.

(ML 36007).

On December 20th, initiation at the agreed upon 3-1 ran into a stumbling block: the GoTo stock price was below $10. On January 4, 2001, Campbell e-mailed the investment bankers, Mazzucco and Andrew Siegel, research management wanted to initiate coverage with a 3-2 (neutral/accumulate) on *GOTO*." (ML 3799). Siegel vigorously opposed the 3-2 rating in a reply to Blodget and Campbell:

> Please listen to my VM [voice mail] from this morning. Briefly, in talking to Ray Abbott [head of compliance] yesterday, I thought the strategy was to go out with the 3-1 as soon as the stock hit $10; if it doesn't, I don't think anybody has an interest in seeing initiation at 3-2.

Id.

Blodget's immediate response was his "concern . . . that waiting for $10 is waiting for Godot. . . ." *Id.* When the stock didn't hit $10 the next day, Mazzucco asked a research analyst if she would arrange for GoTo to have an opportunity to promote itself at an upcoming conference of institutional investors. (ML 29750). The GoTo stock finally traded intra-day at $10 on January 10th, and Blodget initiated coverage

the next day at the 3-1 rating acceptable to the investment bankers and GoTo. (ML 00404 - 08).

The final research initiation report for GoTo that was submitted to research compliance described Looksmart as rated at 3-1. Not surprisingly, compliance crossed out the 3-1 and wrote 2-1, the rating Looksmart still enjoyed as of that date. (ML 00709-18). The final research report for Looksmart, issued later that day, affected the downgrade from 2-1 to 3-1, just as GoTo had been promised. (ML 26324-25).

c. Investment Rating Downgrade of GoTo

On April 25, 2001, Blodget and respondent Ed McCabe[4] (a senior analyst who reported to Blodget) upgraded GoTo to a 2-1 (accumulate-buy) rating. (ML 00585-88). On May 16th and 17th, 2001, Blodget and the investment bankers sponsored an investor road show for GoTo's CEO and CFO, after which GoTo's stock rose 20 percent. (ML 04058; ML 29677-78; OV 00217-18).

In May 2001, Mazzucco suggested to GoTo's Tappin the possibility of an equity offering by GoTo, and a meeting was set for May 31st for GoTo and Merrill Lynch to discuss this and other investment banking-related issues. (ML 08737; ML 18489-90). At about the same time, Mazzucco spoke with the CFO of idealab, GoTo's largest stock holder, (Mazzucco, Tr. at 326-30), about the possibility of monetizing idealab's GoTo stock, and that the CFO would "be pitching us as his

4. In mid-April, 2001, Campbell left Merrill Lynch and was replaced on the GoTo research coverage by McCabe.

first choice" for such a transaction. (ML 29680). In the meantime, Blodget continued to publish bullish research reports on GoTo. (ML 00639-42; ML 00643-44).[5]

On May 25th, GoTo's CEO Ted Meisel and Tappin advised Mazzucco that GoTo had decided to proceed with an equity offering, but that the company was leaning towards Credit Suisse First Boston ("CSFB") as the lead book running manager instead of Merrill Lynch.[6] (ML 29644, Exhibit 246). This would prevent Mazzucco from having Merrill Lynch participate in any way in the underwriting of the offering, given the technology group's policy requiring Mardi Lynch to be a book runner manager. Upset at this sudden, adverse turn of events, Mazzucco on the same day drafted an e-mail to be sent to the Chairman and Vice-Chairman of idealab, and the manager/general partner of idealab Capital Partners, all of whom were also Directors of GoTo:

> I spoke with Ted Meisel and Todd Tappin [GoTo's CEO and CFO] today and they informed me of their decision to proceed with an offering of stock

---

5. Mazzucco emailed a copy of this research report to the CFO of idealab, commenting: "In it Henry [Blodget] highlights the outlook for the Internet advertising market and reiterates GoTo as a focus stock." (ML 29649-52).

6. The book runner manager of a public offering controls the stock allocations to investors. Being a book runner manager was so important to Merrill Lynch that during the relevant period, its investment banking technology group had an "informal" policy that barred the group from being an underwriter unless it was a book runner manager. (Mazzucco, Tr. at 373-74).

> from both idealab! and GoTo. We think it is a terrific idea and one that we have brought up with them over the past few weeks. I was very dismayed to learn that they were leaning toward CSFB as the lead book running manager, particularly given the tremendous effort we have put forth on the Company's behalf. Not only did Henry Blodget show leadership by initiating on the stock near its low point but he recently upgraded it and sponsored a set of investor and Merrill sales force meetings for management in New York, which dramatically moved the stock price . . . As book running manager, I am confident that we are best position to ensure that execution and therefore deliver for both GoTo and Idealab!. An alternative structure would be Merrill Lynch and CSFB as joint book-running managers . . . Your support would be most appreciated. . . . (Exhibit 246) (Mazzucco, Tr. at 383-86, 395-400)

Almost simultaneously, within the Internet group, McCabe e-mailed Blodget a draft downgrade of GoTo's stock from its then current 2-1:

> **H,**
> **I don't think I've downgraded a stock on valuation since the mid-90's. Anyway, I threw together these bullets in a note on my hard drive so that we are ready to pull the trigger quickly. Do you think we need more than bullets? I didn't think so since this downgrade would be based solely on valuation? Let me know.**
> **Thanks.**
> **Ed**

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> • ***GoTo* has doubled since our upgrade about a month ago. We are downgrading the stock due to valuation.**
>
> • **We believe fundamentals are intact . . .**

(ML 04097) (emphasis in original).

Blodget's immediate three-word reaction was: "beautiful fuk em." *Id.*

But if valuation concerns truly were driving the downgrade, the timing was inexplicable. The GoTo stock closing price on May 25th was $22.75 — virtually the same as the price of $23 at which Blodget in the two earlier research reports — May 22nd and May 23rd — had recommended the stock with a bullish 2-1 rating. (ML00639-42; ML 00643-44).

The downgrade was not issued, but held in reserve as Merrill Lynch continued to lobby to be book running manager. (Mazzucco, Tr. at 375-81). On May 29th Mazzucco and Siegel placed GoTo's equity offering on Merrill Lynch's Grey Scan system, to note Merrill Lynch's pursuit of that banking deal. (Abbott, Tr. at 283-84, ML 02022-24). However, on the evening of May 29th, Mazzucco e-mailed Siegel that he had just learned GoTo had decided to retain CSFB as sole book running manager, and that the May 31st banking meeting with GoTo was off (ML 29643). Further, Siegel's calendar for June 1st states: "Take GoTo off greylist for follow-on," (ML 28908), and in fact Merrill Lynch did not participate as an underwriter in the offering.

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On the morning of June 6th Blodget was alerted that GoTo had announced the filing of its SEC registration statement for a proposed offering of 2,500,000 shares plus a resale of 5,000,000 shares held by idealab. CSFB was the book running manager and lead underwriter of the offering. (Exh. 46). Merrill Lynch thus had lost the underwriting for the equity offering, the opportunity to monetize GoTo stock of idealab, and the chance for other business from the now-cancelled May 31st meeting. Moreover, the European private placement of almost a year earlier had never come to fruition. (Mazzucco, Tr. at 331-33; ML 29643).

Within an hour of the announcement of the equity offering, research compliance received the proposed downgrade of GoTo that McCabe had sent Blodget on May 25th, with minor changes. Ray Abbott, head of research compliance, testified that McCabe claimed that Blodget and McCabe had been watching the GoTo stock price for several days, that the stock had exceeded their published price objective, that they were looking for an event which might cause the stock to trend downward, and that the announcement of the GoTo offering was precisely such an event. (Abbott, Tr. at 319-21;413-16). By mid-morning on June 6th, the Blodget downgrade of GoTo from 2-1 to 3-1 was released to the public in substantially the same form that had elicited Blodget's enthusiastic and blunt reaction on May 25th.

Although the downgrade purportedly resulted from the increased stock price and the announcement of the equity secondary offering, the downgrade tellingly makes no mention of the equity offering, much less that the offering

would drive the GoTo stock price down. (ML00649-50). McCabe explicitly recognized this contradiction in an e-mail he sent to Blodget two days after the downgrade: "just had to explain to a client we didn't *downgrade* due to offering." (ML 04124) (emphasis in original). Finally, Abbott conceded that if he had seen Blodget's May research report recommending GoTo with a robust 2-1 rating at a price of $23 — which was already 21 percent above Blodget's published price objective — "it should have raised a red flag" about the downgrade. (Abbott, Tr. at 363-65).

2. INFOSPACE

Merrill Lynch initiated coverage of InfoSpace in December 1999 with a rating of 2-1 (accumulate-buy) and a price objective of $160. The stock then traded at $152.50. Shortly thereafter, Merrill Lynch upgraded the rating to 1-1. As of March 2, 2000, the price had reached $261, but thereafter the stock steadily dropped. Yet Merrill Lynch's Internet group maintained a 1-1 rating on the stock to December 10, 2000, when the price was $13.69.[7] No sell rating was ever issued.

Throughout 2000, Merrill Lynch strongly supported InfoSpace. By March 21, 2000, it had upgraded its rating to a 1-1 (buy-buy), even though the stock was down considerably from its high, and concerns about the company's accounting practices had surfaced. The price objective nevertheless was then at $200. (ML 00002).

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7. From December 1999 to December 2000, the stock split twice, each time at two for one.

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Around this time, Merrill Lynch was courting investment banking business from Go2Net, a technology company. On an April 5, 2000 conference call, Blodget and Mazzucco gave Go2Net, a "presentation" about Merrill Lynch's investment banking and research abilities. In written materials, Blodget was promoted with a photograph and InfoSpace was listed as one of Merrill Lynch's covered stocks. (ML 09260-61; ML 09279-80).

While the Internet group continued to promote InfoSpace stock with buy/buy ratings, Merrill Lynch brokers began to raise numerous and serious questions about Merrill Lynch's support of the stock in e-mails to Blodget and respondent Sofia Ghachem between April and July: "What is the deal with InfoSpace . . . [I] feel reluctant to push it these days," (ML 05795) "should we be concerned about this . . . InfoSpace reported a loss of 38 cents a share, compared to a loss of 3 cents per share a year ago. . . ." (ML 05902) and "the stock continues to underperform and . . . few mutual fund managers are buying this stock . . . maybe we should re-evaluate our stance, i am really concerned for our clients." (ML 06230). Ghachem also was questioned about InfoSpace's management selling their shares of the stock. (ML 06228-29).

By June 1, 2000, the stock price had fallen to $43, but Merrill Lynch continued its buy/buy ratings. (ML 00049-50). On June 15, 2000, Blodget e-mailed Ghachem, confessing "enormous skepticism" about the stock. (ML 06257-58). On June 20, Ghachem e-mailed Blodget to inform him that investment banking was meeting with InfoSpace on June 27th and the bankers had promised InfoSpace that Blodget would appear. (ML 06334).

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Merrill Lynch's buy ratings continued into early July 2000. On July 10, 2000, Go2Net went on Merrill Lynch's Grey Scan list, because Go2Net had asked Merrill Lynch to undertake a sale of Go2Net to InfoSpace. (ML 02026-27). The next day, Merrill Lynch issued a "company update" — commonly referred to as a "booster shot" – on InfoSpace reiterating its buy rating. (ML 00068-69). Unlike several other company updates on InfoSpace, no discernable reason was given for the update. In mid July, Blodget complained to Ghachem, "I'm getting killed on this thing," (ML 06417), yet his buy ratings for InfoSpace continued, even as the stock dropped further in price.

On October 26, 2000, Merrill Lynch completed the sale of Go2Net to InfoSpace. (ML 02027). On December 11, 2000, Merrill Lynch finally reduced its rating to accumulate; the price had hit $13. On December 20, 2000, Merrill Lynch issued a research bulletin indicating that InfoSpace's Vice-President had filed a lawsuit against InfoSpace's CEO, alleging multiple securities violations and racketeering. (ML 00384-87; ML 00397).

From July 2000 through April 2001, e-mails reflect tremendous doubts by the Merrill Lynch analysts as to the future of InfoSpace and the ethics of its CEO. While Merrill Lynch's rating sat at 1-1 with a price objective of $100, its analysts graphically observed that the stock "is a piece of junk" and "toast" if the CEO leaves. (ML 06578; ML 6407-08). When a Merrill Lynch broker wrote to Blodget commenting on InfoSpace's poorly written 1999 annual report. Blodget responded, to Ghachem that he "would love to reset the price target to $30 or something." (ML 06577).

Even after Merrill Lynch finally downgraded the stock to 2-1 in December of 2000, the stock still enjoyed an "accumulate" rating, despite the Internet group's frank internal comments about "what a sleazebag" the CEO was and how Blodget now was "officially not comfortable" with the CEO being associated with the company. (ML 00397; ML 06769-70; ML 06771-72).

The evidence suggests that business considerations influenced the Internet group in maintaining its buy rating for InfoSpace as long as it did. The group regarded InfoSpace important to Merrill Lynch's banking business, as evidenced by a May 17, 2000 e-mail to a member of the Merrill Lynch retail staff:

> This company [InfoSpace] is very important to us from a banking perspective, in addition to our institutional franchise. . . .

(ML 48862) (adding that "non-deal roadshows" for companies such as InfoSpace "have a tremendous effect on our banking efforts).

III. NECESSITY OF THE SECTION 354 ORDER

The foregoing summary of some of the evidence gathered by the Attorney General's investigation to date pursuant to GBL § 352 demonstrates that profoundly troubling questions pervade Merrill Lynch's research and rating system, as that system has been employed by the company's Internet group. Contrary to the image of objectivity that Merrill Lynch has sought to cultivate for its research arts, the evidence shows

that analysts knowingly compromised their honestly held beliefs regarding the merits of particular stocks and skewed the ratings they issued in order to promote the interests of Merrill Lynch's investment banking business, and that the analysts' involvement in that business netted them substantial monetary rewards. The investing public, of course, knew nothing of the inherent conflict of interest underlying the Merrill Lynch rating system, and was deprived of the analysts' honest opinions.

The Attorney General is charged with the responsibility of investigating the commission of fraudulent practices by securities promoters and has authority, under GBL §353, to bring a plenary action on behalf of the public to seek redress and to enjoin entities and individuals from, *inter alia*, committing fraudulent practices, ever directly or indirectly engaging or participating in the issuing, offering or selling of securities, or providing investment advice, within or from the State of New York. The Attorney General also may prosecute Martin Act violations criminally under GBL §352-c.

Section 354 provides that once the Attorney General has decided to commence an enforcement action under the Martin Act, he may apply to the Court for preliminary relief and judicial supervision of the continued gathering of evidence. At this stage in the investigation, the Attorney General has determined that such action is appropriate and shall be commenced against the respondents. The testimony and documents requested are material and necessary for the Attorney General to establish the full scope of the Martin Act violations revealed by the investigation to date. However,

the public and the community of securities regulators need not, and should not, await the outcome of the Attorney General's investigation before they can receive preliminary relief and address the serious problems exposed by the record amassed to date.

Potential purchasers of securities are entitled to both a complete investigation of this matter and immediate injunctive relief. Unless the application herein is granted, the investing public will be deprived of knowledge and safeguards vital to the integrity of our securities industry. Accordingly, pending further development of the record, respondents should be restrained and enjoined in the manner set forth in the proposed order submitted herewith.

The Attorney General intends to continue his investigation and examine the conduct of other major participants in the securities industry. To this end, several other investment banks currently are under Martin Act subpoena to produce evidence regarding their stock research and ratings function. The Attorney General anticipates that after the evidence sought has been produced and studied further application to this Court may be warranted for broader public investigation and eventual relief.

WHEREFORE, the Attorney General respectfully requests that this Court grant the within application for an Order pursuant to GBL Section 354, with the accompanying injunctive relief, in the form annexed hereto, and for such further and other relief as the Court may deem just and proper.

Eric R. Dinallo, Assistant Attorney General

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News from
Attorney General
Eliot Spitzer

Department of Law
120 Broadway
New York, NY 10271

Department of Law
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Contact: Juanita Scarlett
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For immediate release:
April 8, 2002

MERRILL LYNCH STOCK RATING SYSTEM FOUND BIASED BY UNDISCLOSED CONFLICTS OF INTEREST

Spitzer Obtains Court Order Requiring Key Disclosure

State Attorney General Eliot Spitzer today announced a court order requiring immediate reforms in investment counseling by one of the nation's oldest and largest securities films.

The court action against Merrill Lynch was the result of an investigation by Spitzer that concluded that the firm's supposedly independent and objective investment advice was tainted and biased by the desire to aid Merrill Lynch's investment banking business.

Spitzer cites dramatic evidence that the firm's stock ratings were biased and distorted in an attempt to secure and maintain lucrative contracts for investment banking services. As a result, the firm often disseminated misleading information that helped its corporate clients but harmed individual investors.

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"This was a shocking betrayal of trust by one of Wall Street's most trusted names," Spitzer said. "The case must be a catalyst for reform throughout the entire industry."

Spitzer's office uncovered a major breakdown in the supposed separation between the banking and research divisions at Merrill Lynch. In fact, analysts at Merrill Lynch helped recruit new investment banking clients and were paid to do so. The public, however, was led to believe that research analysts were independent, and that the firm's rating system would assist them in making critical investment decisions.

As part of a quid pro quo between the firm and its investment banking clients, Merrill Lynch analysts skewed stock ratings, giving favorable coverage to preferred clients, even when those stocks were dubious investments.

This problem and other conflicts of interest are revealed by internal e-mail communications obtained during the investigation by the Attorney General's office.

These communications show analysts privately disparaging companies while publicly recommending their stocks. For example, one analyst made highly disparaging remarks about the management of an internet company and called the company's stock "a piece of junk," yet gave the company, which was a major investment banking client, the firm's highest stock rating.

The communications show analysts complaining about pressure from Merrill Lynch's investment banking division. For example, a senior analyst writes: "the whole idea that we are independent of (the) banking (division) is a big lie."

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A senior manager stated: "We are off bases in how we rate stocks and how much we bend over backwards to accommodate banking." But nothing was done to remedy this fundamental problem.

The communications show that the problems at Merrill Lynch went far beyond a single analyst or research unit. For example, the head of the equity division wrote to analysts: "We are once again surveying your contribution to investment banking . . . please provide complete details on your involvement . . . paying particular attention to the degree your research played a role in originating. . . . <banking business.>"

And most importantly, the communications show how individual investors were harmed. A research analyst complained about giving a buy rating to a poor investment: "I don't think it is the right thing to do. John and Mary Smith are losing their retirement because we don't want a client's CEO to be mad at us."

The court order obtained by Spitzer requires Merrill Lynch to now make disclosures to investors about its relationship with investment banking clients and provide more context for its stock ratings.

Spitzer described the court order as a preliminary step designed to protect investors while the investigation continues. He said his office has issued subpoenas to other securities firms. The nearly year long investigation is being handled by the Attorney General's Investment Protection Bureau, under the direction of Assistant Attorney General Eric Dinallo.

APPENDIX G — TRANSFER ORDER DATED OCTOBER 11, 2002

RELEASED FOR PUBLICATION

DOCKET NO. 1484

BEFORE THE JUDICIAL PANEL ON MULTIDISTRICT LITIGATION

IN RE MERRILL LYNCH & CO., INC., RESEARCH REPORTS SECURITIES LITIGATION

BEFORE WM. TERRELL HODGES, CHAIRMAN, JOHN F. KEENAN, MOREY L. SEAR,* BRUCE M. SELYA, JULIA SMITH GIBBONS, D. LOWELL JENSEN AND J. FREDERICK MOTZ, JUDGES OF THE PANEL

TRANSFER ORDER

This litigation presently consists of 43 actions: 39 actions in the Southern District of New York; and one action each in the District of New Jersey, the Western District of Oklahoma, the Western District of Texas, and the Western District of Washington.[1] Before the Panel is a motion, pursuant to

* Judge Sear took no part in the decision of this matter.

1. The Panel has been notified that 80 potentially related actions have been filed: 51 actions in the Southern District of New York; three actions each in the District of Arizona, the Northern District of California, and the Northern District of Texas; two actions each in the Central District of California, the Middle District of Florida, the Eastern District of Michigan, the District of Minnesota, the (Cont'd)

28 U.S.C. § 1407, by defendants Merrill Lynch & Co., Inc., and Merrill Lynch, Pierce, Fenner & Smith Inc. (Merrill Lynch) to centralize these actions in the Southern District of New York for coordinated or consolidated pretrial proceedings. Nearly all responding parties support Section 1407 centralization of claims against the Merrill Lynch defendants in a single federal court, but disagree on the most appropriate transferee district. In addition to the Southern District of New York, responding parties suggest selection of the Western District of Oklahoma or the District of Minnesota as transferee district. The *InfoSpace, Inc.* (*InfoSpace*) defendants in the Western District of Washington action (*InfoSpace*) along with several other parties oppose inclusion of claims against the *InfoSpace* defendants in MDL-1484 proceedings and ask the Panel to sever and simultaneously remand these claims to the Washington federal court. The *InfoSpace* plaintiffs oppose inclusion of their action in MDL-1484 proceedings, oppose severance and remand of the claims against the *InfoSpace* director/officer defendants, and ask the Panel to transfer one New York action to the Western District of Washington. Some additional responding plaintiffs also oppose inclusion of their action or potential tag-along action in MDL-1484 pretrial proceedings.

(Cont'd)
Southern District of Mississippi, and the District of New Jersey; and one action each in the Southern District of California, the Northern District of Illinois, the Western District of Kentucky, the District of Maryland, the District of Oregon, the Middle District of Pennsylvania, the Southern District of Florida, and the Western District of Tennessee. These actions and any other related actions will be treated as potential tag-along actions. *See* Rules 7.4 and 7.5, R.P.J.P.M.L., 199 F.R.D. 425, 435-36 (2001).

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On the basis of the papers filed and hearing session held, the Panel finds that the actions in this litigation involve common questions of fact, and that centralization under Section 1407 in the Southern District of New York will serve the convenience of the parties and witnesses and promote the just and efficient conduct of the litigation. All actions share factual questions arising out of allegations that i) from 1999 through 2001, Merrill Lynch and various individually named related defendants issued false and misleading analyst reports concerning publicly traded securities of primarily internet companies in order to promote business for Merrill Lynch's investment banking division, and ii) Merrill Lynch failed to disclose this conflict of interest between its research and investment banking divisions. Centralization under Section 1407 is thus necessary in order to eliminate duplicative discovery, prevent inconsistent pretrial rulings (especially with respect to questions of class certification), and conserve the resources of the parties, their counsel and the judiciary.

Several parties urge the Panel to include the *InfoSpace* action in MDL-1484 pretrial proceedings and to sever and simultaneously remand claims against the *InfoSpace* defendants to the Western District of Washington. The *InfoSpace* plaintiffs oppose this request primarily on the ground that this action includes allegations that the *InfoSpace* defendants conspired with the Merrill Lynch defendants to mislead investors. The presence of conspiracy allegations in *InfoSpace* is debatable and we are reluctant, on the record now before us, to make a determination that claims in *InfoSpace* are severable. It may be, on further refinement of the issues and close scrutiny by Judge Milton Pollack, that

claims against the *InfoSpace* defendants can be remanded to the Western District of Washington for further proceedings in advance of claims against the Merrill Lynch defendants. Should Judge Pollack deem Section 1407 remand of any claims appropriate, procedures are available whereby this may be accomplished with a minimum of delay. *See* Rule 7.6, 199 F.R.D. at 436-38. In any event, transfer of all claims in all actions to a single district under Section 1407 has the salutary effect of placing all the related actions before a single judge who can formulate a pretrial program that: 1) allows pretrial proceedings with respect to any non-common issues to proceed concurrently with pretrial proceedings on common issues, *In re Multi-Piece Rim Products Liability Litigation*, 464 F. Supp. 969, 974 (J.P.M.L. 1979); and 2) ensures that pretrial proceedings will be conducted in a manner leading to the just and expeditious resolution of all actions to the overall benefit of the parties. We are confident in Judge Pollack's ability to streamline pretrial proceedings in all actions, while concomitantly directing the appropriate resolution of all claims.

Although any of the suggested federal districts would be an appropriate forum for Section 1407 proceedings in this litigation, the Panel has decided to entrust this litigation to the Southern District of New York, where 39 constituent actions and 51 potential tag-along actions are pending. We note that this district i) is conveniently located for many parties and witnesses, and ii) possesses the necessary resources to be able to devote the substantial time and effort to pretrial matters that this complex docket is likely to require.

Appendix G

IT IS THEREFORE ORDERED that, pursuant to 28 U.S.C. § 1407, the actions listed on the attached Schedule A and pending outside the Southern District of New York are transferred to the Southern District of New York and, with the consent of that court, assigned to the Honorable Milton Pollack for coordinated or consolidated pretrial proceedings with the actions pending there,

FOR THE PANEL:

s/ Wm. Terrell Hodges
Wm. Terrell Hodges
Chairman

Appendix G

SCHEDULE A

MDL-1484 — In re Merrill Lynch & Co., Inc., Research Reports Securities Litigation

District of New Jersey

William C. Ciemny v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al., C.A. No. 1:02-2576

Southern District of New York

In re Merrill Lynch InfoSpace Analyst Reports Securities Litigation, C.A. No. 1:01-6881

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Lou A. Murphy v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3050

Aaron Priest v. Merrill Lynch & Co., Inc., et. al., C.A. No. 1:02-3189

Abraham Twersky Family Trust v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3210

Jack B. McBride v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3252

John Deleo v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3321

Leonard Corwin v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3366

Roger Matthews, et al. v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3371

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Dwight Corkins v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3372

Jason Silver v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3394

Jon M. Rosenbaum v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3410

James Crowdus v. Merrill Lynch & Co. Inc., et al., C.A. No. 1:02-3417

Sanjay Israni v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3418

Frank J. Vonder Haar v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3429

Harold Ducharme v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3431

Bernd Toennesmann v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3466

Michael M. Moore v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3509

Wayne Boyce v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3510

Ira Atlas v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3513

David Foushee v. Merrill Lynch & Co., Inc., et at., C.A. No. 1:02-3599

Giuseppe Coppola v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3600

Steven Wald v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3606

Bernd Toennesmann v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3634

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Turgut Ergun v. Merrill Lynch & Co., Inc., et al., C.A. No. 1.02-3675

Daniel R. Gerrity v. Merrill Lynch & Co., Inc., et al., C.A. No. *1:02-3690*

Doug Seindenburg v. Merrill Lynch & Co. Inc., et al., C.A. No. 1:02-3714

Paul Hesano v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3715

Robert Rueben v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3759

Victor Parker, etc. v. Merrill Lynch & Co., Inc., et al., C.A. *No.* 1:02-3835

Jason Cho v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3882

Fredell D. Williams v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3934

Seth B. Marks v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-3975

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Dean E. Hart v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-4058

Stephen A. McKernan v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-4140

Steven Smith v. Merrill Lynch & Co., Inc., C.A. No. 1:02-4205

J. James Walsh v. Merrill Lynch & Co., Inc., et al., C.A. No. 1:02-4228

Samuel Sinay, et al. v. Merrill Lynch & Co., Inc., et at, C.A. No. 1:02-4237

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Western District of Oklahoma

Shadi Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., C.A. No. 5:02-564

Western District of Texas

William A. Clearly v. Merrill Lynch Securities, C.A. No. 5:02-364

Western District of Washington

John Horton, et al. v. InfoSpace Inc., et al., C.A. No. 2:01-913

No. 04-1371

Supreme Court, U.S.
FILED
NOV 14 2005
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, preempts state law "holder" class actions brought on behalf of persons who assert that they were induced by allegedly fraudulent statements or omissions to hold (*i.e.*, refrain from selling), as opposed to purchase or sell, securities?

STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page ii of its Petition for a Writ of Certiorari. There are no amendments to that statement.

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B. This Court has broadly construed the "in connection with" language of section 10(b) that is imported into SLUSA's preemption provision. 24

C. The *Blue Chip Stamps* purchaser-seller standing limitation is not a construction of section 10(b) and thus is not imported into SLUSA. 29

II. Importing into SLUSA the Purchaser-Seller Standing Limitation Would Frustrate Congress' Purpose and Lead to an Absurd Interpretation of the Statute. 33

A. Congress enacted SLUSA to curb the filing of securities class actions in state courts. 34

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit (Pet. App. 1a-52a) is reported at 395 F.3d 25 (2d Cir. 2005). The order of the district court (Pet. App. 53a-55a) is unreported.

JURISDICTION

The opinion and order of the court of appeals was entered on January 11, 2005. A petition for a writ of certiorari was filed on April 11, 2005 and granted on September 27, 2005. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The pertinent provisions of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), 15 U.S.C. §§ 77p & 78bb(f),[1] Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder by the Securities Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5 (2005), are set forth in an appendix to this brief ("Br. App.").

In pertinent part and subject to inapplicable exceptions reproduced and appended to this brief, section 28(f) of the 1934 Act, as amended by SLUSA, provides:

> (1) *Class Action Limitations.* No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging (A) a misrepresentation or omission of a material fact in connection with the purchase or sale

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1. SLUSA's amendments to section 16 of the Securities Act of 1933, 15 U.S.C. § 77p, and section 28(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(f), are nearly identical. For ease of reference, Merrill Lynch hereafter cites only the 1934 Act amendment, 15 U.S.C. § 78bb(f).

> of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1) (Br. App. 8a).

STATEMENT OF THE CASE

The question presented in this case requires this Court to construe the scope and meaning of the broad preemptive language Congress used when it enacted SLUSA. Congress expressly preempted (with certain specified statutory exceptions that are not at issue in this case) private covered class actions brought in either state or federal court that seek damages under state law theories for allegedly fraudulent devices, misrepresentations or omissions "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). Congress set forth SLUSA's preemptive scope and effect in extremely broad language: "*No* covered class action" which is "based upon the statutory or common law of any State" may be maintained in "any State or Federal court" "by *any* private party" who "allege[s]" either a misrepresentation of a material fact or a deceptive device or contrivance "in connection with the purchase or sale of a covered security." *Id.* (emphasis added).

Congress did not limit SLUSA preemption to suits brought by purchasers or sellers of securities, but rather provided for preemption of all class actions "by any private party" alleging misrepresentations or deceptive practices "in connection with" the purchase or sale of securities. The operative language of SLUSA's preemption provision that is relevant to this case, "in connection with the purchase or sale" of a covered security, tracks the language contained in section 10(b) of the 1934 Act, which this Court has broadly interpreted as not limiting coverage to deception of an identifiable purchaser or seller.

In the decision below, the court of appeals held that putative plaintiffs may avoid the preemptive scope of SLUSA and proceed

with their state law class actions if they allege that they held, rather than purchased or sold, securities as a result of the alleged misrepresentations. In so deciding, the court imported into SLUSA's preemption provision an extratextual purchaser-seller limitation. Yet, the purchaser-seller rule upon which the court relied was created by this Court on policy grounds as a standing limitation on the judicially created private damages remedy under section 10(b). This Court clearly has stated that the purchaser-seller standing rule is not a construction of the "in connection with the purchase or sale" language in section 10(b).

The court of appeals' interpretation of the scope of SLUSA's preemption provision as limited by the "purchaser-seller" standing rule is therefore inconsistent with the plain language and natural meaning of the broad statutory text. In addition, the court of appeals' decision frustrates the legislative scheme enacted in SLUSA, by which Congress sought to further a uniform national legal regime with respect to nationally traded securities by disallowing private class actions from proceeding under disparate state substantive and procedural standards.

As the Seventh Circuit concluded in a subsequent decision by Judge Easterbrook directly conflicting with the opinion below, "[i]t would be more than a little strange" if this Court's decision to limit the standing of non-traders to bring potentially vexatious and hypothetical claims under federal law "became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities laws or not at all." *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005), *reh'g denied*, No. 04-1495, 2005 U.S. App. LEXIS 7914 (7th Cir. May 2, 2005), *petition for cert. filed*, 74 U.S.L.W. 3232 (U.S. Sept. 29, 2005) (No. 05-409).

1. Statutory Background

a. Private Securities Litigation Reform Act of 1995

After years of fact-finding, reports and debate, Congress passed the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (the "PSLRA") (codified in part at 15 U.S.C. §§ 77z-1, 78u-4). The purpose of the PSLRA was to improve the efficiency of the capital markets and to foster economic growth by deterring frivolous and burdensome securities litigation and by improving the flow of information to the markets. *See* S. Rep. No. 104-98, at 4-7 (1995).

Among other things, the PSLRA implemented a number of "needed procedural protections to discourage frivolous litigation." H.R. Conf. Rep. No. 104-369, at 31-32 (1995). These included:

(1) Heightened pleading standards for federal securities fraud claims, *see* 15 U.S.C. § 78u-4(b)(1), (2);[2]

(2) A stay of discovery during the pendency of any motion to dismiss, *see* 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3);

(3) Lead plaintiff provisions designed to ensure that a plaintiff with a significant stake in the litigation, rather than a class action lawyer, would control the case, *see* 15 U.S.C. §§ 77z-1(a)(3), 78u-4(a)(3); and

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2. The PSLRA "insists that securities fraud complaints 'specify' each misleading statement; that they set forth the facts 'on which [a] belief' that a statement is misleading is 'formed'; and that they 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" *Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1633 (2005) (quoting 15 U.S.C. § 78u-4(b)(1), (2)). Further, the PSLRA requires plaintiffs to plead and prove that the misconduct alleged "'caused the loss for which the plaintiff seeks to recover.'" *Id.* (quoting 15 U.S.C. § 78u-4(b)(4)).

(4) Sanctions for frivolous litigation, *see* 15 U.S.C. §§ 77z-1(c), 78u-4(c).

Certain of these measures were designed to facilitate early dismissal of nonmeritorious actions or "strike suits," before the expenses of discovery and litigation might push defendants toward settlement rather than resolution on the merits. *See, e.g., Dura Pharms., Inc. v. Broudo*, 125 S. Ct. 1627, 1633 (2005) (PSLRA's strictures are intended to make securities fraud actions "available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause").

Substantively, the PSLRA established "a safe harbor for forward looking statements, to encourage issuers to disseminate relevant information to the market without fear of open-ended liability." H.R. Conf. Rep. No. 104-369, at 32; *see* 15 U.S.C. §§ 77z-2(c), 78u-5(c). "'Understanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm.'" H.R. Conf. Rep. No. 104-369, at 43 (quoting testimony of former SEC Chairman Richard Breeden). The statutory safe harbor was therefore enacted to provide some measure of insulation from liability for a company's disclosure of projections and other forward-looking statements where such statements were accompanied by "meaningful cautionary statements," 15 U.S.C. §§ 77z-2(c)(1)(A), 78u-5(c)(1)(A), or where plaintiffs failed adequately to allege that such statements were made with "actual knowledge" of their falsity, 15 U.S.C. §§ 77z-2(c)(1)(B)(i), 78u-5(c)(1)(B)(i).

b. Securities Litigation Uniform Standards Act of 1998

Less than three years after the passage of the PSLRA, Congress enacted SLUSA "in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]." Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353,

§ 2, 112 Stat. 3227, 3227. In SLUSA, Congress enacted a provision of express preemption.

Specifically, SLUSA preempts any "covered class action based upon the statutory or common law of any State" brought "in any State or Federal court" in which "any private party" alleges a "misrepresentation or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance" "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). SLUSA provides that if such a state law class action is filed in state court, it may be removed to federal court, *see* 15 U.S.C. § 78bb(f)(2), and dismissed as preempted by federal securities law, *see* 15 U.S.C. § 78bb(f)(1).

A "covered class action" is defined as any single lawsuit (or group of lawsuits filed in the same court that involve common questions of law or fact) "in which damages are sought on behalf of more than 50 persons or prospective class members." 15 U.S.C. § 78bb(f)(5)(B).[3] A "covered security" is generally a nationally traded security that is listed or authorized for listing on certain national securities exchanges. *See* 15 U.S.C. § 78bb(f)(5)(E) (referring to 15 U.S.C. § 77r(b)(1)) (Br. App. 12a-13a, 7a). This definition of "covered security" leaves intact the states' police powers "to craft laws governing fraud occurring wholly within their borders . . . in face-to-face transactions." *Securities Litigation Uniform Standards Act of 1997: Hearings on S. 1260 Before the Subcomm. on Securities of the S. Comm. on Banking, Hous. & Urban Affairs*, 105th Cong. 46 (1997) (hereinafter, "*1997 Hearing on S. 1260*") (statement of then-SEC Chairman Arthur Levitt, Jr.).

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3. Derivative actions are specifically excluded from the definition of a "covered class action." *See* 15 U.S.C. § 78bb(f)(5)(B), (C). "The derivative form of action permits an individual shareholder to bring 'suit to enforce a *corporate* cause of action against officers, directors, and third parties.'" *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (emphasis in original) (citation omitted).

SLUSA contains three carefully crafted categories of actions that are expressly preserved from preemption, *see* 15 U.S.C. § 78bb(f)(3) (Br. App. 8a-10a), none of which was present in the earlier versions of the bill and none of which mentions actions by holders of securities.

The first provision, the so-called "Delaware carve-out," 15 U.S.C. § 78bb(f)(3)(A), was the direct result of concerns expressed by the SEC Chairman that an early version of the bill might unintentionally preempt a significant and venerable body of corporate law, particularly in Delaware, relating to issuers' disclosure obligations in the context of mergers and other extraordinary transactions. *See 1997 Hearing on S. 1260, supra*, at 47-48. Thus, SLUSA expressly preserves state court jurisdiction over state law claims arising in the proxy solicitation or tender offer context relating to equity holders' decisions about how to vote in a tender offer or exchange offer, or in exercising dissenters' rights or appraisal rights. *See* 15 U.S.C. § 78bb(f)(3)(A)(ii).

The second exception to SLUSA's preemption expressly preserves state court jurisdiction of securities fraud suits "brought by a State or political subdivision thereof or a State pension plan." 15 U.S.C. § 78bb(f)(3)(B). Senator Sarbanes noted that there was no history of state and local governments "abus[ing] the system" as private securities plaintiffs. 144 Cong. Rec. S4811 (daily ed. May 13, 1998).

The third exception expressly preserves state court jurisdiction for actions under contractual agreements between issuers and indenture trustees to enforce the conditions of the indenture. *See* 15 U.S.C. § 78bb(f)(3)(C). This exception addressed concerns that the broad preemptive nature of SLUSA would prevent bondholders, through the indenture trustee, from enforcing certain negotiated contractual rights such as representations, warranties or covenants.

Additionally, SLUSA contains a savings clause clarifying that state securities commissions and agencies or offices performing similar functions retain their jurisdiction under state laws "to investigate and bring enforcement actions." 15 U.S.C. § 78bb(f)(4) (Br. App. 11a); *see also* H.R. Rep. No. 105-640, at 16 (1998). In fact, SLUSA enacted provisions to facilitate reciprocal subpoena enforcement among state securities regulators in order to enhance state enforcement abilities. Pub. L. No. 105-353, § 102, 112 Stat. 3227, 3233 (Br. App. 14a).

Senator Dodd, one of the Senate bill's sponsors, emphasized that SLUSA was a balanced piece of legislation that created a national standard for class action litigation involving nationally traded securities:

> It will not affect the ability of any state agency to bring any kind of enforcement action against any player in the securities markets;
>
> It will not affect the ability of any individual, or even a small group of individuals to bring a suit in state courts against any security, nationally traded or not; [and]
>
> It will not affect any suit, class action or otherwise, against penny stocks or any stock that is not traded on a national exchange.

144 Cong. Rec. S4791 (daily ed. May 13, 1998) (statement of Sen. Dodd); *see also* H.R. Rep. No. 105-640, at 9 (describing the exceptions to preemption); H.R. Conf. Rep. No. 105-803, at 13-14 (1998) (same).

2. Factual Background [4]

Petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") is a full-service financial services firm engaged in, among other things, underwriting securities offerings to the public, offering brokerage services and investment advice and providing research on approximately 3,000 publicly traded issuers worldwide.

On April 8, 2002, the New York Attorney General filed an *ex parte* motion and affidavit in a New York State court seeking an order to obtain testimony and other discovery from several Merrill Lynch research analysts and managers. The discovery was sought in an effort to support a public enforcement action (never initiated) relating to the content of ratings and research reports on Internet stocks by Merrill Lynch's research analysts. (A 73a-75a.) The State Attorney General, asserting broad enforcement power and potential remedies under New York's Martin Act (which does not require allegations of intent, reliance, damages or the purchase or sale of securities), *see* N.Y. Gen. Bus. Law §§ 352-359-h (McKinney 1996 & Supp. 2005), ultimately negotiated a settlement with Merrill Lynch.[5]

In the weeks following the New York Attorney General's court filings and the attendant media publicity, over 150 putative class actions were commenced against Merrill Lynch in no fewer than twenty jurisdictions nationwide. Of this number, over 140 asserted claims under section 10(b) of the 1934 Act and SEC Rule 10b-5 promulgated thereunder. These federal actions

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4. At this motion to dismiss stage of the proceedings, allegations of fact set forth herein – drawn from the Complaint or Amended Complaint and the exhibits thereto – are accepted as true only for purposes of review. *See Lemon v. Kurtzman*, 403 U.S. 602, 620 (1971).

5. Subsequently, the New York Attorney General, acting together with federal regulators (the SEC, the New York Stock Exchange and the National Association of Securities Dealers), reached a global settlement with many of the industry's full-service financial firms. *See SEC v. Bear, Stearns & Co.*, 2005 WL 217018 (S.D.N.Y. Jan. 31, 2005).

alleged that plaintiffs and the purported class members on whose behalf they claimed to act purchased securities of a variety of internet and high-technology companies based on allegedly false or misleading research reports issued by Merrill Lynch. Six other putative class actions, including Mr. Dabit's, sought relief under state law theories based on the same alleged conduct asserted in the federal securities complaints. *See* Pet. App. 55a.[6]

a. Plaintiff's Initial Complaint

Mr. Dabit, a former Merrill Lynch broker, commenced his diversity action in the United States District Court for the Western District of Oklahoma on April 26, 2002. (A 27a.) He asserted claims for compensatory and punitive damages for breach of fiduciary duty and breach of the covenant of good faith and fair dealing under Oklahoma common law. (A 43a-45a.)

Among other things, Mr. Dabit alleged that Merrill Lynch's research analysts "made materially false and misleading statements [in Merrill Lynch's research reports and recommendations] designed to encourage Plaintiff and Plaintiff's clients to purchase [48 different internet and technology] stocks." (A 38a ¶ 34.) The securities which were the subject of Mr. Dabit's complaint were identified on an exhibit attached to his complaint. (A 28a ¶ 1, 46a, 70a-71a.) He further alleged that when the New York Attorney General's allegations became known, "the price of certain stocks steadily declined, leaving Plaintiff and clients of Plaintiff who purchased these stocks at manipulation-inflated prices with substantial losses." (A 29a ¶ 5.)

Mr. Dabit asserted that he was induced to hold, as well as purchase, securities as a result of the alleged misrepresentations and that "had he been advised of the true facts, [he] would have

6. All six of these state law actions were dismissed by the district court as preempted by SLUSA. *See* Pet. App. 6a-7a. Plaintiffs in only two of the six actions appealed those determinations, both of which were addressed in the decision below. *See id.*

sold them and advised his clients to sell them well before the . . . [s]tocks dramatically declined in value." (A 29a ¶ 7.) His putative class action claims were brought on behalf of himself and all other former or current Merrill Lynch account executives who, while employed by Merrill Lynch, "*purchased* one or more of the [48] ML recommended securities . . . individually or on behalf of Brokers' clients at any time during the period from December 1, 1999 through December 31, 2000 (the 'Class Period')," and who suffered damages as a result of *owning and holding* such ML Stocks during this time period, or who suffered damages as a consequence of the loss of clients due to ML's wrongful actions." (A 28a ¶ 1 (emphasis added).)

Merrill Lynch moved to dismiss Mr. Dabit's complaint as preempted by SLUSA because it was a class action brought under state law alleging that Merrill Lynch made material misrepresentations and omissions in connection with the purchase or sale of nationally traded securities. (A 22a.) The Oklahoma federal district court dismissed the complaint as preempted, with leave to replead. (A 47a-50a.)

b. Plaintiff's Amended Complaint

Mr. Dabit filed an amended complaint on October 21, 2002. This pleading remained essentially unchanged from the original complaint, except for a few word replacements. As the Second Circuit later described, "[i]n his amended complaint . . . Dabit replaced the original complaint's references to purchases of securities with references instead to the owning or holding of securities." (Pet. App. 5a-6a; *compare, e.g.*, A 29a, 37a-38a, 41a ¶¶ 5, 30, 34-35, 48 *with* A 53a, 60a-62a, 64a ¶¶ 5, 27, 31-32, 45.) Thus, for example, in his first complaint, Mr. Dabit had alleged that Merrill Lynch's research analysts "made materially false and misleading statements designed to encourage Plaintiff and Plaintiff's clients to purchase the ML Stocks." (A 38a ¶ 34.) In his amended complaint, he alleged Merrill Lynch's research analysts "made materially false and misleading statements

designed to encourage Plaintiff and Plaintiffs' clients to *continue to hold* the ML Stocks." (A 61a ¶ 31 (emphasis added).)

Mr. Dabit also substituted "owned and continued to own" for the word "purchase" in his putative class definition in paragraph 1 of his complaint. Thus in his amended complaint, he sought to represent himself and all other former or current Merrill Lynch brokers who "*owned and continued to own* one or more of the ML recommended securities" during the putative class period and "who suffered damages as a result of *owning and holding* such ML Stocks during this time period, or who suffered damages as a consequence of the loss of clients due to ML's wrongful actions further described herein." (A 52a ¶ 1 (emphasis added); *compare* A 28a ¶ 1.)

In both Mr. Dabit's initial complaint and the amended complaint, the asserted misstatements made by Merrill Lynch consisted of allegedly misleading research reports concerning publicly traded companies. The research reports published by Merrill Lynch consist of "detailed financial information and investment analysis," *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 176 (2d Cir.), *cert. denied*, 74 U.S.L.W. 3228 (U.S. Oct. 11, 2005) (No. 05-24), as well as recommendations such as "buy" or "accumulate," reflecting the research analyst's expectation of the subject stock's "appreciation potential" over the intermediate (within 12 months) and longer (12-24 months) term. *Id.* at 166. Merrill Lynch's research reports also contained "high" risk ratings which, as the Second Circuit found in the related federal class actions, "incontestib[ly]" disclosed "the risk of price volatility – and hence, the risk of implosion – on the face of every report." *Id.* at 176.

The gravamen of Mr. Dabit's amended complaint is that Merrill Lynch's allegedly false and misleading research reports caused the prices at which 48 specified securities were traded on the public markets to be artificially inflated. Mr. Dabit alleges that he and other brokers were damaged in the market value of

their holdings and in their client relationships when the New York Attorney General's investigation became public and the market prices for the various securities declined significantly. He asserts that "had [Plaintiff] been advised of the true facts, [he] would have sold [the securities] . . . well before the ML Stocks dramatically declined in value." (A 53a-54a ¶ 7.)

In an effort to circumvent SLUSA preemption, Mr. Dabit's amended complaint carefully attempts to avoid allegations that he purchased or sold securities during the putative class period in reliance on the alleged misstatements. *Cf. Kircher*, 403 F.3d at 482 ("Assuming that SLUSA's 'in connection with' [preemptive] language means 'able to pursue a private right of action after *Blue Chip Stamps*,' plaintiffs attempted to frame complaints that avoid any allegations of purchase or sale."). Nevertheless, virtually every aspect of Mr. Dabit's amended complaint alleges conduct by Merrill Lynch that is claimed to have affected the price at which securities were being purchased and sold. (*See, e.g.*, A 53a ¶ 4 ("[T]he price of the ML Stocks promoted by ML were artificially inflated as a result of the manipulative efforts of ML. . . . ML was able to, and did, manipulate the price of the ML Stocks, causing these stocks to trade at artificially inflated prices."); A 53a ¶ 5 (ML's conduct "prevent[ed] Plaintiff from selling his personally held stocks at minimal loss"); A 53a ¶ 6 (ML used "a variety of deceptive devices, artifices and tactics that are the hallmarks of stock manipulation"); *see also* A 59a-60a ¶ 26 (ML reports "were false and contained misleading statements, designed to artificially inflate and artificially support the price of the ML Stock").)

Mr. Dabit alleged further that Merrill Lynch interfered with the actual selling of securities:

> [Merrill Lynch] artificially propped up the price of various . . . [s]tocks by *refusing to execute and otherwise actively discouraging the execution of orders to sell these stocks. These efforts improperly*

> *restrained investor selling*, caused the supply of these stocks in the marketplace to be understated, caused the demand for the stocks in the marketplace to be overstated and, as a result, further caused the price of these stocks to be artificially inflated and/or maintained.

(A 54a-55a ¶ 11 (emphasis added).) Mr. Dabit also alleged that Merrill Lynch and various of its agents, affiliates and employees were selling the subject securities during the relevant period. (A 54a ¶ 9, A 63a ¶ 40.)

3. The Proceedings Below

The Judicial Panel on Multidistrict Litigation transferred the various pending actions, including Mr. Dabit's, to the Honorable Milton Pollack, Senior United States District Judge for the Southern District of New York, for coordinated pretrial proceedings. (Pet. App. 6a-7a; A 121a-129a; A 12a.) The Panel explained that it granted Merrill Lynch's motion for a transfer because Mr. Dabit's action "share[d] factual questions" with the federal class actions brought under section 10(b) of the 1934 Act. (A 123a.)

Merrill Lynch moved to dismiss Mr. Dabit's amended complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, on the ground that it was a "covered class action" proceeding under state law theories that alleged misrepresentations, omissions and manipulative and deceptive devices in connection with the purchase or sale of securities and, therefore, was preempted under SLUSA. (A 12a.) Judge Pollack granted the motion and dismissed the amended class action complaint as preempted, finding it self-evident that "[t]he claims alleged . . . f[e]ll squarely within SLUSA's ambit" because they were "based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court." (Pet. App. 55a.)

Mr. Dabit appealed. Following oral argument, the Second Circuit requested answers from the SEC to specific posed questions. (A 5a-7a.) The SEC responded in an Amicus Brief (A 8a; Pet. App. 72a-100a) as follows: (1) The "in connection with" language in SLUSA has the same meaning as the phrase is used in section 10(b) of the 1934 Act (*see* Pet. App. 80a-83a); (2) adoption of a purchaser-seller limitation on SLUSA preemption is not consonant with either the statutory language or SLUSA's legislative purpose (*see* Pet. App. 88a-94a); and (3) where the statutory requirements are satisfied, SLUSA preempts class actions under state law that could not have been brought pursuant to section 10(b) and Rule 10b-5 (*see* Pet. App. 87a, 95a-99a).

4. The Decision Below

On January 11, 2005, the Second Circuit issued its opinion affirming in part and vacating in part the district court's decision. (Pet. App. 1a-52a.) The Second Circuit held that the judicially crafted purchaser-seller standing rule that was adopted by this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), as a standing limit on implied private rights of action for money damages under section 10(b) of the 1934 Act also "applies as a limit on SLUSA's 'in connection with' requirement such that SLUSA does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members." (Pet. App. 3a-4a.) In so importing this judicially crafted rule of standing into SLUSA's enacted language, the Second Circuit disagreed with the SEC. (*See* Pet. App. 26a-36a.)

The court below began with the premise agreed upon and urged by all parties and the SEC – that interpretation of SLUSA's "in connection with" language should be undertaken by reference to the extensive body of law construing the same language in section 10(b). (Pet. App. 17a.) In next turning to the issue of whether so-called "holder" claims were preempted by SLUSA, the Second Circuit acknowledged that the purchaser-

seller limitation was a "rule of standing" (Pet. App. 24a), adopted by this Court in light of "policy considerations" (Pet. App. 25a). The court went on to note that "[t]he limitation on standing to bring private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities." (Pet. App. 27a.)

Nevertheless, the court concluded that "the fact that the standing rule is analytically distinct from the underlying prohibition on fraud does not compel the conclusion that SLUSA preempts more than the purchaser/seller category of private damage actions over which the 'in connection with' source language operates." (Pet. App. 28a.) To the contrary, "it is far more natural to suppose that Congress *meant to import* the settled standing rule along with the 'in connection with' phrase as a substantive standard." (*Id.* (emphasis added).) Presumably because it concluded Congress "meant to import" the judicially created standing rule into the "in connection with" statutory language, the court held that Congress in fact did so. The court so held despite the fact that the purchaser-seller standing limitation appears nowhere in SLUSA's language and despite the court's earlier recognition that the standing rule was a prudential, policy-based judicial limit which "is unquestionably a distinct concept from the general statutory and regulatory prohibition" encompassed in the statute's language.

Having "*suppose[d]* that Congress *meant to import*" a standing limitation as a substantive scope restriction that does not appear in the statute, the court then looked to legislative history to determine whether anything there *disproved* a theorized intent by Congress to do what the court concluded it must have meant to do without so saying. The Second Circuit relied upon statements by members of Congress that SLUSA would further the purposes of the PSLRA "by stemming the migration of claims from federal to state court." (Pet. App. 21a.)

From this the court below concluded, once again disagreeing with the SEC (*compare* Pet. App. 29a-35a *with* Pet. App. 88a-99a), that a broad statement of congressional intent was a statement of limitation and that SLUSA was intended to preempt *only* those state law class actions that were "capable of being brought under federal law." (Pet. App. 21a.)

The Second Circuit acknowledged that the legislative history "generally indicates a broad preemptive intent." (Pet. App. 31a). It also recognized in a parenthetical that "Congress may have been unaware of the existence of state law holding claims when it enacted SLUSA." (Pet. App. 32a). Yet despite these acknowledgments, the court appears to have placed great weight on its observation that "holder" claims were not listed among the "*examples* of *non*-preempted claims" noted in a statement by a single Senator. (Pet. App. 33a (emphasis added).) The court did not address the statute's limited and carefully crafted exceptions to preemption or the fact that holder claims are not included within those exceptions.

Applying the foregoing reasoning to Mr. Dabit's amended complaint, the Second Circuit held that Mr. Dabit's "holding" claims, as pled, were preempted by SLUSA because his putative class definition failed to exclude persons who also purchased securities during the putative class period. (Pet. App. 38a-39a.) The court concluded:

> Given the close relationship in most instances between a holding claim and the purchase of securities, and given SLUSA's manifest intent to preempt state-law claims alleging fraud in connection with an actual purchase, it is sensible to require a would-be "holding" lead plaintiff expressly to exclude from the class claimants who purchased in connection with the fraud and who therefore could meet the standing requirement for maintenance of a 10b-5 action.

(Pet. App. 43a.)

Having determined that properly pled "holder" claims are not preempted by SLUSA, the court permitted Mr. Dabit the opportunity to replead so as to exclude from his putative holder class any person who purchased securities during the class period after an alleged misrepresentation. (*See* Pet. App. 43a.)

In direct conflict with the decision below, the Seventh Circuit, in an opinion by Judge Easterbrook, held that claims by holders of mutual fund securities are preempted by SLUSA. *See Kircher*, 403 F.3d at 484. The Seventh Circuit concluded that the "in connection with the purchase or sale" language in SLUSA "is as broad as § 10(b) itself" and is not affected by "limitations on private rights of action to enforce § 10(b)," such as the purchaser-seller requirement rule adopted by the Court in *Blue Chip Stamps*. *Id.* "To say that SLUSA uses the same language as § 10(b) and Rule 10b-5 is pretty much to resolve the point." *Id.* at 483; *see also Disher v. Citigroup Global Mkts. Inc.*, 419 F.3d 649, 654-55 (7th Cir. 2005).

This Court granted certiorari in the wake of the split among the circuit courts on this important issue of federal statutory law.

SUMMARY OF ARGUMENT

The court of appeals erred in concluding that Mr. Dabit might plead a state law holder class action that could survive preemption under SLUSA. As a statute of express preemption, SLUSA's preemptive scope necessarily is determined by reference to the plain language and natural meaning of the statute. That language requires class actions asserting holder claims to be preempted.

The broad preemptive language Congress enacted in SLUSA does not limit preemption to suits brought by purchasers or sellers of securities, but rather provides for preemption of all class actions "by any private party" alleging misrepresentations or deceptive practices "in connection with" the purchase or sale of securities. It is not disputed that the

phrase "in connection with the purchase or sale" of securities in SLUSA's preemption provision has the same meaning as it does in section 10(b) of the 1934 Act. This Court has consistently and expressly held that the alleged fraud need not be perpetrated on an identifiable purchaser or seller of a security in order for it to be "in connection with" the purchase or sale of securities and therefore actionable under section 10(b), so long as the fraud "touches upon" or coincides with a securities transaction *by someone*.

The purchaser-seller standing limitation that this Court adopted in *Blue Chip Stamps* does not alter or construe the scope of section 10(b) coverage or the meaning of section 10(b)'s "in connection with the purchase or sale" language imported into SLUSA. As this Court has stated, most recently in its *O'Hagan* decision announced one year before the passage of SLUSA, the purchaser-seller rule is not a construction of the text or scope of section 10(b), but rather is a policy-based, judicially imposed standing limit on the availability of particular remedies (private damages actions) available to enforce section 10(b). There accordingly is no basis to import that standing rule to limit the plain language of SLUSA's preemptive scope.

Any contrary holding would frustrate the purposes of SLUSA and lead to an irrational statutory result. Holder claims are precisely among the type of claims that this Court in *Blue Chip Stamps* concluded were the most vexatious, having an *in terrorem* effect and settlement value wholly out of proportion to their underlying merit – or lack thereof. They rely on a paradoxical, speculative and potentially non-cognizable theory of damages that is based on the alleged ability of plaintiffs to benefit from asserted misrepresentations on an insider basis, at the expense of the marketplace. Yet under the court of appeals' reasoning, holder claims would survive preemption whereas claims by purchasers would be preempted and allowed to be brought only in federal court subject to the PSLRA's stringent pleading and proof standards (or not at all). Holder plaintiffs

would thus have at their disposal an arsenal of potential procedural and substantive state law remedies foreclosed to purchasers or sellers.

Such a result would not only be irrational. It would stand as an obstacle to the accomplishment of Congress' objectives in SLUSA – to promote uniformity in the national securities markets, to prevent flight of vexatious and unmeritorious class actions from federal to state court where they can escape the heightened standards of the PSLRA and to encourage companies' disclosures to the marketplace.

ARGUMENT

I. The Language and Natural Meaning of SLUSA Require Express Preemption of State Law Class Actions Asserting Holder Claims.

"If [a] statute contains an express pre-emption clause, the task of statutory construction must in the first instance focus on the plain wording of the clause, which necessarily contains the best evidence of Congress' pre-emptive intent." *CSX Transp., Inc. v. Easterwood*, 507 U.S. 658, 664 (1993); *see also Ingersoll-Rand Co. v. McClendon*, 498 U.S. 133, 138 (1990) ("To discern Congress' intent we examine the explicit statutory language and the structure and purpose of the statute.").

In extremely broad express language, SLUSA preempts covered private class actions for damages brought by "any private party" based upon state law. It provides that "no covered class action" which is "based upon the statutory or common law of any State" may be maintained in "any State or Federal court" "by any private party" who "alleg[s]" either a misrepresentation of a material fact or a deceptive device or contrivance "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). Covered class actions asserting "holder" claims fall within the scope of this broad express

preemption provision. Pursuant to SLUSA, holder class actions seeking damages under state law must be dismissed or, if initially filed in state court, may properly be removed to federal court and then dismissed. *See* 15 U.S.C. § 78bb(f)(1), (2).

A. Under the natural meaning of the phrase, state law holder claims allege misrepresentations "in connection with the purchase or sale" of a security.

The natural meaning of SLUSA's preemption clause "is conspicuous for its breadth." *FMC Corp. v. Holliday*, 498 U.S. 52, 58 (1990) (addressing ERISA's broad "relate to" preemptive language). This is especially true with respect to the broad "connection with" language which this Court has held to be, in the context of interpreting another statute and as a purely textual matter of natural meaning, unquestionably expansive in scope. *See New York State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 656 (1995) (interpreting ERISA).

In class actions asserting "holder" claims under state law, plaintiffs allege they were induced to hold, rather than to buy or sell, securities during the relevant class period. Such claims necessarily allege fraud or misrepresentations "in connection with the purchase or sale" of securities in at least three respects.

First, holder claims, including Mr. Dabit's, are premised on allegations that a misrepresentation or deceptive scheme inflated the company's publicly-traded share price. *See supra*, pp. 11-14 (allegations of amended complaint). Yet manipulation or misrepresentations that artificially inflate (or depress) trading prices of publicly-traded securities cannot occur without trading, *i.e.*, purchases and sales of securities. Here, the alleged fraud – that Merrill Lynch promoted (and, through its brokers, sold) securities by issuing allegedly misleading research reports and recommendations "designed to artificially inflate and artificially support the price of the ML Stock" (A 59a-60a ¶ 26) and allegedly "improperly restrained investor selling" further causing "the

price of these stocks to be artificially inflated" (A 54a-55a ¶ 11) – is in connection with actual purchases and sales of securities by market participants at prices affected by publicly disseminated research reports.

Second, holder class actions allege misstatements "in connection with the purchase or sale" of securities because they assert that as a result of the asserted misrepresentations, the plaintiffs *refrained from selling* securities at a point in time at which plaintiffs claim they otherwise would have. In other words, holders essentially assert that the alleged misrepresentations altered the timing of their sale of securities and they claim damages based on their missed opportunity to sell the securities at prices higher than what a later sale did or might garner once the alleged misrepresentations were revealed. Such a claim is naturally "in connection with the purchase or sale" of securities, whether that claim is characterized as one in which a plaintiff holds securities or as one in which a plaintiff refrains from selling securities. Mr. Dabit additionally alleges that Merrill Lynch and various of its agents, affiliates and employees were selling the subject securities during the relevant period. (A 54a ¶ 9, A 63a ¶ 40.)

Third, the damages sought to be recovered in holder claims are based on the allegedly diminished value at which the plaintiffs' securities eventually were sold or might yet be sold. Just as "[s]hares are normally purchased with an eye toward a later sale," *Dura Pharms.*, 125 S. Ct. at 1631, so also are shares held with an eye toward a later sale. To allege damages or loss as a holder, therefore, a plaintiff must allege actual or anticipated future sales of securities at collapsed market value. Whether the sale has actually been effectuated or is yet anticipated, the damages sought by holder claims are "in connection with the purchase or sale" of securities.

Notably, for a claim to fall within SLUSA's preemptive scope, the alleged misrepresentation need not necessarily be "in connection with the purchase or sale of securities" *by the*

plaintiff asserting such claims. It is sufficient that the alleged misrepresentation be in connection with the purchase or sale of securities *by someone*. Where Congress has intended to limit statutory coverage or liability only to acts directed to the actual purchasers or sellers of the securities in question, rather than broadly "in connection with" the purchase or sale of a security by someone through the impersonal securities exchanges, it has done so expressly. *See, e.g.*, 15 U.S.C. § 78r(a) (providing right of action for misleading statements in SEC filings to "any person . . . who, in reliance upon such statement shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance . . ."); 15 U.S.C. § 77k(a) (providing right of action by reason of a false registration statement to "any person acquiring" the security); 15 U.S.C. § 77*l*(a) (providing right to sue a seller of a security who had engaged in proscribed practices "to the person purchasing such security from him"); 15 U.S.C. § 78t-1(a) (providing right of action against someone who illegally trades on inside information "to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class").

In SLUSA, by contrast, Congress employed the broader, impersonal language preempting claims by "*any* private party" asserting misrepresentations "*in connection with* the purchase or sale" of securities. (emphasis added.) Because every unique word in a statute must be interpreted as having distinct meaning, *see Dole Food Co. v. Patrickson*, 538 U.S. 468, 476-77 (2003) (statutes should be construed, if possible, so that "'every word has some operative effect'") (citation omitted), SLUSA should not be read as preempting only those claims that involve misrepresentations to a purchaser or seller of securities, rather than in connection with the purchase or sale of securities. *See also Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 383, 385 (1992) (petitioner's contention that a provision preempting state law "relating to rates, routes, or services" "only pre-empts the States from actually prescribing rates, routes, or services . . . simply reads the words 'relating to' out of the statute").

B. This Court has broadly construed the "in connection with" language of section 10(b) that is imported into SLUSA's preemption provision.

It is not disputed that the phrase "in connection with" in SLUSA has the same meaning as it does in section 10(b) of the 1934 Act, particularly because SLUSA amended the 1934 Act. *See Gustafson v. Alloyd Co.*, 513 U.S. 561, 570 (1995) ("[T]he 'normal rule of statutory construction' [is] 'that identical words used in different parts of the same act are intended to have the same meaning.'") (citation omitted); *accord IBP, Inc. v. Alvarez*, No. 03-1238, slip op. at 6-7, 10-13 (U.S. Nov. 8, 2005) (Court's construction of "principal activity" in one part of a statute held to have the same meaning in another part of the same statute).

Section 10(b) makes it unlawful for any person "[t]o use or employ, *in connection with the purchase or sale of any security* . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b) (emphasis added). Every court of appeals to address SLUSA's preemptive scope, including the court below, has held that its "in connection with" language "has the same scope as its antecedent in section 10(b) and Rule 10b-5." *Kircher*, 403 F.3d at 482; *see also Dabit*, 395 F.3d at 34-36; *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 299 (3d Cir. 2005); *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1129-31 (9th Cir. 2002), *amended on other grounds*, 320 F.3d 905 (9th Cir. 2003); *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342-43 (11th Cir. 2002); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 596-97 (8th Cir. 2002). If conduct falls within the broad prohibitory language of section 10(b), private state law covered class actions seeking damages for such conduct are preempted under SLUSA as well.

This Court has consistently adopted a broad reading of the phrase "in connection with the purchase or sale" of securities in the context of section 10(b) that does not limit coverage of the section to deception directed at or affecting identifiable purchasers or sellers. *See United States v. O'Hagan*, 521 U.S.

642, 658 (1997). Most recently, in *SEC v. Zandford*, 535 U.S. 813 (2002), the Court held that conduct may be "in connection with" the purchase or sale of securities even if the conduct did not affect the trading decisions of the defrauded parties or concern the value of securities, so long as the alleged fraud "coincided" with securities transactions by someone. *Id.* at 819-20. The Court held that a broker's "'scheme to defraud' . . . throughout [a] 2-year period during which [the broker] made a series of transactions [unknown to his clients] that enabled him to convert the proceeds of the sales of [his clients'] securities to his own use," was "in connection with" the securities transactions because the transactions were necessary to accomplish the allegedly fraudulent scheme. *Id.* at 820-21 ("The securities [transactions] and respondent's fraudulent practices [are] not independent events."). This Court rejected the broker's contention that his sales of the securities, because perfectly lawful in themselves, were separate events from the misappropriation of the proceeds – which occurred subsequently – and thus insufficient to violate section 10(b), *see id.* at 820, holding that "[i]t is enough that the scheme to defraud and the sale of securities coincide." *Id.* at 822.

Notably, in *Zandford* the defrauded party was not the person making investment decisions and the alleged fraud did not even concern the value of securities or the investment decisions – as it indisputably does in this case. Yet this Court went so far as to expressly reject the proposition that the "in connection with" language could be limited to violations related to "'market integrity or investor understanding.'" *Id.* at 818 (citation omitted). The Court noted that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* at 820; *see also id.* at 819 (noting that "the SEC has consistently adopted a broad reading of the phrase 'in connection with the purchase or sale of any security'"); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12-13 (1971) (holding actionable under section 10(b) "deceptive practices touching"

the sale of securities).[7] Thus, while *Zandford* refused to limit the scope of section 10(b) to fraud concerning the value of securities or investment decisions, it undeniably found such fraud to fall squarely within the scope of section 10(b).

Similarly, in *O'Hagan*, 521 U.S. 642, the alleged fraudulent conduct did not affect the investment decisions of the defrauded party and did not wrongfully induce anyone to purchase or sell securities. The Court held that Mr. O'Hagan violated section 10(b) and Rule 10b-5 when he defrauded his law firm's client by using the client's inside information concerning a planned tender offer to purchase the securities of the target company for his own account. The fraud against the third party (in that case, the client) who owned confidential information merely coincided with or touched upon securities transactions *by someone* (in that case, by the defendant himself, who used the misappropriated information to purchase or sell securities). *See id.* at 647-48, 659-59.

This Court stated explicitly and unequivocally that section 10(b), "as written, does not confine its coverage to deception of a purchaser or seller of securities; rather, the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'" *Id.* at 651 (citation omitted); *see also id.* at 658 (section 10(b)'s "language . . . requires deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller").

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7. The SEC has frequently taken the position in formal adjudications that an alleged fraud need not concern the value of a particular security or aim at the purchase of a security to be "in connection with the purchase or sale," so long as it "coincided with" or subsequently resulted in nonfraudulent purchases or sales by someone. *See, e.g., In re Orlando Joseph Jett*, File No. 3-8919, 2004 SEC LEXIS 504, at *69-73 (Mar. 5, 2004) (employer required to purchase securities to effectuate what were previously illusory exchanges); *In re Scott Simon Fraser*, File No. 3-11271, 2003 SEC LEXIS 2269, at *6 (Sept. 25, 2003); *In re Genesis Trading*, File No. 3-10194, 2000 SEC LEXIS 858, at *6-10 (May 1, 2000).

> [A] fiduciary's fraud is consummated . . . when, without disclosure to his principal, he uses [confidential] information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. *This is so even though the person or entity defrauded is not the other party to the trade.* . . . "[A] fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons."

Id. at 656 (emphasis added) (quoting Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading in Nonpublic Information*, 13 Hofstra L. Rev. 101, 120 (1984)); *id.* at 660 ("We . . . note again that § 10(b) refers to 'the purchase or sale of any security,' not to identifiable purchasers or sellers of securities.").

Significantly, *O'Hagan* involved a criminal prosecution, in which principles of lenity applicable to criminal statutes would mitigate against a broad reading of a statutory provision, if ambiguous. *See O'Hagan*, 521 U.S. at 679 (Scalia, J., concurring in part, dissenting in part). Nevertheless, the majority adopted the broad reading of the "in connection with" language. The purchase or sale of a security can be executed by *anyone* coincidentally with or as a result of the alleged fraud and need not be by the defrauded party in order for the alleged fraud to be "in connection with the purchase or sale" of securities.

There can be no doubt, and there is no dispute, that holder claims involving publicly traded securities allege that the purchase and sale of securities *by someone* coincide with the alleged wrongdoing. In fact, the fraud asserted in holder claims is completed only when some investors are induced by the misrepresentation to trade in securities, because only when there are securities transactions can prices be artificially inflated. Indeed, the "in connection with the purchase or sale"

requirement is met where, as here, the complaint alleges that misrepresentations or omissions are disseminated in a public medium to the marketplace. *See Basic Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988) ("Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or so incomplete as to mislead. . . .") (ellipsis in original) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc)).[8]

Indeed, unlike *Zandford* or *O'Hagan* (where the Court nevertheless found misstatements "in connection with the purchase or sale" of securities), the alleged misstatements at issue here – Merrill Lynch's research reports – addressed the value of the underlying securities with the alleged aim of influencing investment decisions to purchase or sell. Here, Mr. Dabit alleges that Merrill Lynch "published two types of reports which were received by investors" (A 60a ¶ 28); that he was misled into "believing in the honesty and integrity of . . . the ML Stocks' market prices as presented by ML" in the reports

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8. The Second Circuit's interpretation in *Texas Gulf Sulphur* of "in connection with the purchase or sale" as encompassing statements reasonably calculated to influence the investing public has been widely accepted and adopted by several circuit courts of appeal. *See Semerenko v. Cendant Corp.*, 223 F.3d 165, 175-76 & n.5 (3d Cir. 2000); *Herpich v. Wallace*, 430 F.2d 792, 805-06 (5th Cir. 1970); *Britt v. Cyril Bath Co.*, 417 F.2d 433, 435-36 (6th Cir. 1969); *SEC v. Dolnick*, 501 F.2d 1279, 1283-84 (7th Cir. 1974); *McGann v. Ernst & Young*, 102 F.3d 390, 392-94 (9th Cir. 1996); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 101-02 (10th Cir. 1971).

The SEC likewise has consistently adopted the reasoning of *Texas Gulf Sulphur* in formal adjudications. *See, e.g., In re Benjamin C. Snyder*, File No. 3-10871, 2002 SEC LEXIS 1619, at *4-5 (June 25, 2002) (dissemination of false or misleading information over the internet held "in connection with the purchase or sale" even in the absence of any allegations of price inflation or purchases and sales); *In re Charles Plohn & Co.*, File No. 3-4243, 1975 SEC LEXIS 2559, at *49-50 (Oct. 6, 1975); *In re Martin Herer Engelman*, 52 S.E.C. 271, 283 (1995).

(A 60a ¶ 27); that he "relied upon the reports and ratings which ML knew were not accurate and not correct" (A 60a ¶ 28); and that the reports "effect[ed] an artificial inflation and artificial price of the ML Stocks" (A 62a ¶ 34). Such claims fall within the core of statements "in connection with the purchase or sale" of securities, whether or not the defrauded party or plaintiff (rather than someone else) is the actual purchaser or seller of securities. They thus come within the express language of SLUSA's broad preemptive scope.

C. The *Blue Chip Stamps* purchaser-seller standing limitation is not a construction of section 10(b) and thus is not imported into SLUSA.

Although correctly recognizing that SLUSA's "in connection with" language tracks that of section 10(b) and should be construed as having a coextensive scope, the court below went astray when it concluded that the purchaser-seller standing requirement limits the broad prohibitory language enacted by Congress in section 10(b) itself – and therefore limits SLUSA's preemptive scope as well. The standing rule of *Blue Chip Stamps* was adopted by this Court as a *judicially crafted limit* on a *judicially inferred* private remedy to enforce section 10(b), and not as an interpretation of the broad language of section 10(b).

The private damages remedy is one of several available to enforce section 10(b) violations, the others of which are not limited by this standing requirement.[9] In numerous decisions, this Court has stated that the purchaser-seller rule is not based upon a construction of, is not coextensive with and is not even required by the statutory language of section 10(b). It instead

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9. For example, the "purchaser-seller" rule does not limit the SEC's broad enforcement authority under section 10(b), *see Zandford*, 535 U.S. at 819-25, or the federal government's authority to prosecute criminal violations of the securities laws, *see O'Hagan*, 521 U.S. at 651; *United States v. Naftalin*, 441 U.S. 768, 771-73 & n.4 (1979).

constitutes a policy-based standing limit on one of several available remedies to enforce section 10(b). There accordingly is no basis for importing the purchaser-seller restriction applicable to a subset of section 10(b) private enforcement actions into SLUSA's preemption provision.

This Court itself, when it announced the purchaser-seller standing rule in *Blue Chip Stamps*, expressly rejected the suggestion that this limitation could be "divine[d] from the language of § 10(b)." 421 U.S. at 737; *see also id.* at 748-49 ("No language in either of these provisions [section 10(b) and Rule 10b-5] speaks at all to the contours of a private cause of action for their violation."). Rather, the Court considered "what may be described as policy considerations" in arriving at the standing limitation, *id.* at 737, and concluded that there were sufficient advantages to the purchaser-seller rule "purely as a matter of policy." *Id.* at 739. As Judge Easterbrook noted:

> *Blue Chip Stamps* came out as it did not because § 10(b) and Rule 10b-5 are limited to situations in which the plaintiff itself traded securities, but because a private right of action to enforce these provisions is a judicial creation and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm.

Kircher, 403 F.3d at 483.

This Court noted that its standing rule would not limit the prohibitory scope of the enacted language of section 10(b) because "[o]ur decision in *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), established that the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under § 10(b) and Rule 10b-5." *Blue Chip Stamps*, 421 U.S. at 751 n.14. Rather than limiting the scope of the language of section 10(b), the Court determined that the "private cause of action which has been judicially found to exist" under Rule 10b-5 should be "judicially delimited." *Id.* at 749.

The Court expressly recognized that its extratextual, prudential rule of standing would limit some federal claims that otherwise fall within the scope of the statutory language, because it noted the rule would preclude some shareholders from recovering, in a private action, damages caused by fraud "in connection with the purchase or sale" of securities. *See id.* at 738-39.

Even before adoption of the purchaser-seller standing requirement in *Blue Chip Stamps*, this Court was careful to distinguish between the broad coverage of the text of the statutory provisions of the securities laws and judicial limits that may be imposed on private actions brought to enforce them. *See, e.g., SEC v. National Sec., Inc.*, 393 U.S. at 467 n.9 ("in connection with the purchase or sale of any security" is "relevant only to the question of statutory coverage," and in a case brought by the Commission "there are no [*Birnbaum*] 'standing' problems lurking in the case"); *see also Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382 (1970) (in construing a statutory provision of the securities laws, noting the distinction between the effect of an interpretation on actions for "private redress" and "enforcement actions by the Securities and Exchange Commission itself"); *see also Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 657-58 (7th Cir. 1973) (Stevens, J.).

In virtually every pertinent decision after *Blue Chip Stamps*, this Court could not have been "plainer in holding that the questions of liability and relief are separate in private actions under the securities laws." *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 64 (1975); *see also Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 172-73 (1994) (distinguishing between "the scope of conduct prohibited by § 10(b)," and "the elements of the 10b-5 private liability scheme," citing *Blue Chip Stamps* as an "elements" case).

Thus, this Court has consistently described the purchaser-seller requirement of *Blue Chip Stamps* as a rule of standing for one subset (private damages actions) of the types of remedies

available to enforce section 10(b), and not as a construction of the statutory scope or language of section 10(b). *See, e.g., Chiarella v. United States*, 445 U.S. 222, 238 n.* (1980) (Stevens, J., concurring) ("[T]he limitation on the right to recover pecuniary damages in a private action identified in *Blue Chip* is not necessarily coextensive with the limits of [Rule 10b-5] itself."); *United States v. Naftalin*, 441 U.S. 768, 774 n.6 (1979) ("This case involves a criminal prosecution. The decision in [*Blue Chip Stamps*], which limited to purchasers or sellers the class of plaintiffs who may have private implied causes of action under [SEC] Rule 10b-5, is therefore inapplicable.") (citing *National Sec.*, 393 U.S. at 467 n.9).

More recently, in the years preceding passage of SLUSA, the Court was unequivocal in stating that the *Blue Chip Stamps* standing requirement does not limit the language or scope of section 10(b) or Rule 10b-5. In *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258 (1992), four concurring members of this Court – who would have decided the case on other grounds than those addressed by the majority – stated clearly that "[t]he purchaser/seller standing limitation in Rule 10b-5 damages actions . . . does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.'" *Id.* at 284 (O'Connor, J., joined by White and Stevens, JJ., concurring in part and concurring in the judgment); *see also id.* at 289-90 (Scalia, J., concurring in the judgment) ("[T]he limitation we approved in *Blue Chip Stamps* was essentially a legislative judgment rather than an interpretive one.").

Those clear statements by the concurring Justices in *Holmes* were adopted by a majority of the Court in *O'Hagan*, 521 U.S. at 664-65 (citing concurring opinions of Justice O'Connor and Justice Scalia in *Holmes*), one year before SLUSA was adopted. The Court in *O'Hagan* articulated clearly its settled understanding of the scope of section 10(b) as not limited by the purchaser-seller standing requirement: "The provision, as written, does not confine its coverage to deception of a

purchaser or seller of securities; rather the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'" *Id.* at 651 (citation omitted). The Court acknowledged that "[w]e so confined the § 10(b) private right of action because of 'policy considerations.'" *Id.* at 664 (quoting *Blue Chip Stamps*, 421 U.S. at 737). To hold otherwise would mean that *O'Hagan* must be overruled because the defrauded party there was not a purchaser or seller of securities.

It has therefore been the longstanding and consistent view stated by the Court that the purchaser-seller requirement of *Blue Chip Stamps* is a prudential rule of standing and not a construction of section 10(b). Accordingly, there is no basis to conclude that the purchaser-seller standing requirement limits the broad language of SLUSA's preemption provision to less than its natural and understood meaning. Under that meaning, a class action asserting "holder" claims under state law seeks recovery from the effects of misrepresentations on the trading price of securities and, therefore, from misrepresentations "in connection with the purchase or sale" of securities.

II. Importing into SLUSA the Purchaser-Seller Standing Limitation Would Frustrate Congress' Purpose and Lead to an Absurd Interpretation of the Statute.

In the decision below, the Second Circuit did not purport to rely on the natural meaning of the "in connection with" language or upon the interpretation that the same language has been accorded in section 10(b). Yet its resort to legislative history to depart from the established natural, broad meaning of the language used in SLUSA's preemption provision and importation of a judicial rule of standing, which finds no support in the text of the statute, must be rejected. "We must give effect to this plain language [of the preemption provision] unless there is good reason to believe Congress intended the language to have some more restrictive meaning." *Shaw v. Delta Air Lines, Inc.*, 463

U.S. 85, 97 (1983). Here there is no reason to suppose that Congress intended to depart from the statute's natural meaning.

Rather, adoption by this Court of the Second Circuit's unnatural, constricted reading of SLUSA's preemptive language would lead to an irrational statutory result and is contrary to the legislative history. It also would frustrate the comprehensive legislative scheme adopted by Congress. Such a reading accordingly must be rejected under ordinary statutory interpretation rules, as well as principles of implied preemption. *See, e.g., Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S. 341, 352 (2001) (finding implied preemption notwithstanding express preemption provision) (citing *Geier v. American Honda Motor Co.*, 529 U.S. 861 (2000)).

A. Congress enacted SLUSA to curb the filing of securities class actions in state courts.

SLUSA marked the third of a series of major Congressional enactments between 1995 and 1998 designed to further dramatically the development of a uniform nationwide regime of securities law. These enactments modified the Securities Act of 1933 ("1933 Act") and the 1934 Act, both of which were "landmark pieces" of legislation that established the modern securities markets. *Central Bank*, 511 U.S. at 170-71. "The 1933 Act regulates initial distributions of securities, and the 1934 Act for the most part regulates post-distribution trading." *Id.* at 171.

By 1995, Congress found that the number of private securities fraud class actions filed in the United States had grown dramatically, with adverse effects upon the productivity and competitiveness of U.S. businesses. *See* S. Rep. No. 104-98, at 8-10 (1995). Virtually since the initial recognition by this Court of the private damages remedy under section 10(b) and Rule 10b-5, "[t]here has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in

general." *Blue Chip Stamps*, 421 U.S. at 739. This is because large extracted settlements and discovery abuses can result from even unmeritorious complaints. *See id.* at 741 ("a plaintiff with a largely groundless claim [can] simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value" out of proportion to the underlying merits); *accord Dura Pharms.*, 125 S. Ct. at 1634.

The growth in national securities class actions was fueled by the convergence of at least two factors: (1) the liberalization of Rule 23 of the Federal Rules of Civil Procedure in 1966, which substantially expanded the availability of the class action device;[10] and (2) this Court's decision in 1988 permitting plaintiffs to invoke the so-called "fraud on the market" presumption of reliance as a surrogate for actual reliance at the class-certification stage. *See Basic Inc.*, 485 U.S. at 242 (acknowledging that "[r]equiring proof of individualized reliance from each member of the proposed class effectively would have prevented respondents from proceeding with a class action, since the individual issues then would have overwhelmed the common ones").

Among other things, Congress heard reports that it had become commonplace for plaintiffs and their attorneys to file securities class actions with form complaints immediately upon (even just hours after) a significant drop in an issuer's share price, with little or no apparent investigation of any alleged wrongdoing by the defendants or of the underlying merits of

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10. *See, e.g.*, Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 Va. L. Rev. 776, 828-29 (1972) (cited in *Blue Chip Stamps*, 421 U.S. at 740) (explaining that "[p]rior to 1966, a class action based on the existence of common questions was simply a permissive joinder device [binding only parties] ... who appeared as intervenors in the action"). Under the changes in 1966, a putative class includes anyone who has not "opted out," thus vastly increasing the potential liability to issuers as well as the size of attorneys' fees for plaintiffs' counsel. *See id.* at 828-29.

the action. *See, e.g.*, S. Rep. No. 104-98, at 4, 8-9 (1995); H.R. Conf. Rep. No. 104-369, at 31 (1995).

The abusive practices sought to be curbed by the PSLRA included:

> (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action;
>
> (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability;
>
> (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and
>
> (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

H.R. Conf. Rep. No. 104-369, at 31.

To address these concerns, the PSLRA implemented a number of "needed procedural protections to discourage frivolous litigation." *Id.* at 31-32. *See supra* pp. 4-5.

Shortly after the passage of the PSLRA in 1995, a new phenomenon occurred: the plaintiffs' securities bar began to file class actions in state courts in order to avoid the myriad reforms and barriers Congress had enacted to stem abusive federal securities litigation. "Prior to the passage of the [PSLRA], there was essentially no significant securities class action litigation brought in State court." H.R. Rep. No. 105-640, at 10 (1998);

see also H.R. Conf. Rep. No. 105-803, at 14 (1998) (setting forth identical language).[11] Yet in its Report to the President and the Congress on the First Year of Practice Under the [PSLRA], "the SEC called the shift of securities fraud cases from Federal to State court 'potentially the most significant development in securities litigation' since passage of the [PSLRA]." H.R. Rep. No. 105-640, at 10 (citation omitted).

This rise in state court class actions undermined the PSLRA because "essentially none of the [PSLRA's] procedural or substantive protections against abusive suits are available" in state court. H.R. Rep. No. 105-640, at 10; *accord* H.R. Conf. Rep. No. 105-803, at 14-15. In actions that are permitted to proceed under state law, plaintiffs can, for example, proceed under more lenient pleading standards; seek punitive damages; seek to bring claims based on forward-looking statements that would otherwise be covered by the federal safe harbor; and utilize the "*in terrorem*" effects of discovery (which, in many state court actions, is not stayed pending disposition of a motion to dismiss) to extract settlements disproportionate to the actual merits of the action.

As highlighted by Representative Eshoo - co-sponsor of the House SLUSA bill - in her testimony before the Senate:

> Migration to State courts is not a minor problem. It represents an undermining of the core

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11. Both reports cited Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience: A Statistical and Legal Analysis of Class Action Securities Fraud Litigation under the Private Securities Litigation Reform Act of 1995*, Stanford Law School (Feb. 27, 1997). *See also 1997 Hearing on S. 1260, supra*, at 68 (prepared statement of Michael A. Perino) (in 1992, 1993 and 1994, respectively, there were 4, 1 and 1 state class actions alleging fraud in the sale of a publicly traded security); 144 Cong. Rec. H6063 (daily ed. July 21, 1998) (statement of Rep. Deutsch) (noting that by comparison to prior years, there had been a 6000% increase in state securities class action filings after the passage of the PSLRA).

> reforms implemented in the [PSLRA]. This is because the [PSLRA] relies on uniform application and enforcement of the law to be effective. Without this uniform standard, the law is undermined, the strike suits continue and companies and investors are held hostage. This is particularly true for the two key elements of the [PSLRA]: Safe Harbor [for Forward Looking Statements] and Stay of Discovery.

1997 Hearing on S. 1260, supra, at 7. Congress recognized that the shift of class actions to state court could become more acute in the future because "without a national standard for liability, the potential threat is always there that one State will change its laws in such a way as to become the haven for litigation." *Id.* at 15 (opening statement of co-sponsor Sen. Dodd).

In response to these concerns, several bills were introduced in both the House of Representatives and the Senate. The first bill introduced in the House would have preempted, without exception, all private civil actions under state law which alleged "a misrepresentation or omission in connection with the purchase or sale of any covered security" or "that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of any covered security." H.R. 1653, 105th Cong. § 2 (1997). Another House bill would have limited preemption to state law class actions, rather than to all private securities actions brought under state law. The latter bill also contained a removal provision. *See* H.R. 1689, 105th Cong. § 2 (1997).

In the Senate, Senators Gramm, Dodd, Domenici and ten co-sponsors introduced their own version of the legislation. *See* S. 1260, 105th Cong. (1997). This bill mirrored the latter House bill except that it applied only to nationally traded securities and securities of investment companies. *See id.* § 2.

Senator Dodd explained the rationale for preemption of state securities fraud causes of action:

> In general, I believe that the 1995 Reform Act . . . is working pretty well. In fact, . . . it's working so well on the Federal level that weaker claims have migrated from Federal courts to State courts. . . . a development that threatens, I think, the success that we have achieved to date in this general area.

See 1997 Hearing on S. 1260, supra, at 15 (opening statement of Sen. Dodd).

The final version of SLUSA was passed by unanimous consent in the Senate and by a vote of 319-82 in the House. *See* 144 Cong. Rec. S12,450 (daily ed. Oct. 1998); 144 Cong. Rec. H10,800-01 (daily ed. Oct. 13, 1998). President Clinton, who had vetoed the PSLRA, signed SLUSA into law on November 3, 1998.[12]

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12. SLUSA was enacted on the heels of another significant piece of legislation that constituted a further and significant tilt toward uniform national securities law standards. In 1996, Congress enacted the National Securities Markets Improvement Act ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C. §§ 77a, 78a, 80a-1, 80b-1), amending the 1933 Act, the 1934 Act and the Investment Company Act of 1940. Congress did so "to further advance the development of national securities markets and eliminate the costs and burdens of duplicative and unnecessary regulation." H.R. Rep. No. 104-622, at 16 (1996). The House Report noted that "the system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation . . . that, in many instances, is redundant, costly, and ineffective." *Id.* The NSMIA preempts vast areas of state regulation governing the registration and offerings of nationally traded securities by, for example, prohibiting states from imposing any conditions on the content of proxy statements, reports to shareholders or other disclosure documents required to be filed with the SEC. *See* 15 U.S.C. § 77r(a)-(b).

B. The Second Circuit's construction of SLUSA would frustrate Congress' purpose and produce an absurd result that must be rejected.

In the face of SLUSA's carefully crafted provisions designed to prevent vexatious, potentially unmeritorious and burdensome class actions from migrating to state court, Congress most certainly did not intend to allow private securities class actions asserting "holder" claims to survive preemption, whereas state law class actions brought by purchasers and sellers of securities are undisputedly preempted by SLUSA. Any conclusion to the contrary would lead to an irrational result that must be rejected as a matter of statutory interpretation. *See Johnson v. United States*, 529 U.S. 694, 707 n.9 (2000) ("'[N]othing is better settled, than that statutes should receive a sensible construction, such as will effectuate the legislative intention, and if possible, so as to avoid an unjust or an absurd conclusion.'") (alteration in original) (quoting *In re Chapman*, 166 U.S. 661, 667 (1897)).

Holder claims present the greatest risk for the type of vexatious securities litigation that Congress sought to eliminate when it enacted SLUSA. As this Court stated in *Blue Chip Stamps*, the purchaser-seller rule limiting the availability of private redress under section 10(b) was desirable as a policy matter precisely to limit plaintiffs' ability to seek recovery for holder claims through private damage actions:

> [P]urchasers and sellers at least seek to base recovery on a demonstrable number of shares traded. In contrast, a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury such as loss of a noncontractual opportunity to buy or sell, is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective hypothesis.

Blue Chip Stamps, 421 U.S. at 734-35. *See also Kircher*, 403 F.3d at 483 ("The Justices [in *Blue Chip Stamps*] observed that

anyone can *say* that a failure to trade bore some relation to what the issuer did (or didn't) disclose, but that judges and juries would have an exceedingly hard time knowing whether a given counterfactual claim ('I *would have* traded, if only . . .') was honest.") (ellipsis in original).

The speculative nature of evidence and proof in holders cases thus presents a very real risk that the mere pendency of the action "has a settlement value to the plaintiff out of any proportion to its prospect of success at trial." *Blue Chip Stamps*, 421 U.S. at 740. Because such an action "will turn largely on which oral version of a series of occurrences the jury may decide to credit, . . . the case will be virtually impossible to dispose of prior to trial other than by settlement." *Id.* at 742. In holder actions, "bystanders to the securities marketing process" can "await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass." *Id.* at 747.

By contrast to holder claims involving "would have"/"should have"/"could have" plaintiffs, purchasers' and sellers' claims are more readily demonstrable in objective terms. "The fact of purchase of stock and the fact of sale of stock are generally matters which are verifiable by documentation, and do not depend upon oral recollection, . . . [and] can normally be established by the defendant either on a motion to dismiss or on a motion for summary judgment." *Id.* at 742. And yet, under the Second Circuit's reasoning, state law class actions brought by purchasers or sellers of securities are preempted by SLUSA whereas the less verifiable class actions brought by holders of securities are not.

In addition to being among the most vexatious types of claims, holder claims are the least likely to present meritorious grounds for recovery of damages, especially on a class basis.

Holder claims are a relatively recent innovation that have been asserted largely subsequent to the passage of the PSLRA and SLUSA.[13] As the court below recognized, "Congress may have been unaware of the existence of state law holding claims when it enacted SLUSA." (Pet. App. 32a). Such claims arose and have vastly proliferated as artful pleading devices to attempt to avoid the preemptive scope of SLUSA.[14] *See Kircher*, 403 F.3d at 482 ("Assuming that SLUSA's 'in connection with' [preemptive] language means 'able to pursue a private right of action after *Blue Chip Stamps*,' plaintiffs attempted to frame complaints that avoided any allegations of purchase or sale.").

Yet holder claims rest, in essence, upon a paradoxical theory of recovery. Insofar as holders had been induced to purchase, as well as to hold, securities based on alleged misrepresentations (as Mr. Dabit initially pled in his original complaint), then these plaintiffs may seek recovery under section 10(b) as purchasers of securities. In such circumstances, state law holder claims are

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13. Holder claims, as applied to impersonal transactions on the national securities markets, are of recent vintage and the jurisdictions to address them have expressed disparate views as to the treatment of such cases. *See Manzo v. Rite Aid Corp.*, 2002 Del. Ch. LEXIS 147, at *2, *11-13 (Del. Ch. Dec. 19, 2002), *aff'd mem.*, 825 A.2d 239 (Del. 2003); *Small v. Fritz Cos.*, 65 P.3d 1255, 1265-66 (Cal. 2003); *Amzak Corp. v. Reliant Energy, Inc.*, 2004 U.S. Dist. LEXIS 16514, at *16-19 (N.D. Ill. Aug 18, 2004); *Rogers v. Cisco Sys., Inc.*, 268 F. Supp. 2d 1305, 1311-14 & n.18 (N.D. Fla. 2003); *Gordon v. Buntrock*, No. 99 CH 18378, at *6-15 (Ill. Cir. Ct. Ch. Div. July 19, 2004); *In re WorldCom, Inc. Sec. Litig.*, 336 F. Supp. 2d 310, 319-23 (S.D.N.Y. 2004).

14. In light of SLUSA's removal provisions, federal courts since 1998 have frequently confronted holder claims. *See* Pet. at 17 n.5. Published and electronically available decisions since the filing of the Petition for Certiorari include: *Disher*, 419 F.3d 649; *Felton v. Morgan Stanley Dean Witter & Co.*, 2005 U.S. Dist. LEXIS 19484 (S.D.N.Y. Sept. 6, 2005); *In re Lord Abbett Mut. Funds Fee Litig.*, 385 F. Supp. 2d 471 (D.N.J. 2005); *In re Eaton Vance Mut. Funds Fee Litig.*, 380 F. Supp. 2d 222 (S.D.N.Y. 2005); and *Sered v. Bristol-Myers Squibb Co.*, 2005 U.S. Dist. LEXIS 16433 (N.D. Ill. July 1, 2005).

a duplicative and, being inherently unreliable in terms of proof, a vexatious means of allowing additional class action attorneys to evade the heightened requirements of the PSLRA and to seek recovery from the coffers of corporations and their shareholders. *See, e.g., 1997 Hearing on S. 1260, supra,* at 3 (statement of Sen. Faircloth) ("[T]he core issue here is about stopping class action lawsuits that are designed to make certain lawyers rich at the expense of the private sector . . . [while the] shareholders collect pennies on the dollar. . . .").

Insofar as holders purchased prior to the asserted misrepresentations and were later induced by the misrepresentations to refrain from selling at artificially high prices, then they can have suffered no actual damages when the truth comes out in the market, much less suffered legally cognizable or nonspeculative damages. As Judge Friendly noted in *Levine v. Seilon, Inc.*, 439 F.2d 328 (2d Cir. 1971):

> [Plaintiff could not allege any injury] caused by [defendant's] representation since, according to the complaint, if the representation had not been made, the price of his stock would not have been inflated, and there would have been no gain to be realized by a sale.

Id. at 333-34. *See also Crocker v. FDIC*, 826 F.2d 347, 351 n.6 (5th Cir. 1987) (holders cannot allege any cognizable, lawful injury from an alleged misrepresentation because any profit plaintiffs could have made by selling their stock before the market learned the truth "would have resulted from insider trading in violation of the securities laws"); *see also id.* at 351-52.

The allegations in Mr. Dabit's amended complaint in fact underscore this paradox. Mr. Dabit does not allege when he or the putative class members purchased the securities or how the timing of those purchases related to the timing of the asserted

misrepresentations.[15] It is entirely possible that Mr. Dabit's seemingly arbitrary putative class period was constructed artfully simply to avoid alleging securities purchases in an attempt to avoid bringing federal claims subject to the burdens of the PSLRA. Such an attempt should be rejected as directly contrary to SLUSA. As Judge Easterbrook noted, "plaintiffs' effort to define non-purchaser-non-seller classes is designed to evade [the] PSLRA in order to litigate a securities class action in state court in the hope that a local judge or jury may produce an idiosyncratic award. It is the very sort of maneuver that SLUSA is designed to prevent." *Kircher*, 403 F.3d at 484.

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15. Mr. Dabit included no allegations as to why he began his putative class period as late as December 1, 1999 or why he ended it on December 31, 2000. He did not allege the dates on which the misrepresentations or falsified research reports were issued or how the timing of those misrepresentations related to when he purchased the securities in question. Nor did he allege when he might otherwise have sold the securities but for the misrepresentations. Mr. Dabit incorporated by reference the New York Attorney General's affidavit (A 55a ¶ 12) and exhibited it to his complaint (A 72a-117a), but the affidavit in turn stated that the alleged misstatements on the part of Merrill Lynch took place during a broader period, "[f]rom the spring of 1999 to the fall of 2001." (A 82a.)

It is entirely possible that, depending on when he purchased the securities included in his amended complaint, Mr. Dabit might be, with respect to some of the same securities, a member of the putative classes in purchaser class actions under section 10(b) that allege deceptively-induced purchases of securities during a period predating the start of Mr. Dabit's putative class period. *E.g.*, Civ. No. 02-CV-3452 (S.D.N.Y) (motion to dismiss pending) (Aether stock; class period Nov. 15, 1999 to Feb. 7 2001); Civ. No. 02-CV-7218 (S.D.N.Y.) (motion to dismiss pending) (CMGI stock; class period Mar. 23, 1999 to Oct. 27, 2000); Civ. No. 02-CV-3050 (S.D.N.Y.) (motion to dismiss pending) (Internet Capital stock; class period Aug 5, 1999 to Oct. 8, 2000); *see also In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 416 (S.D.N.Y. 2003) (dismissing complaint concerning eToys stock; putative class period July 17, 1999 to Nov. 8, 2000), *appeal pending*; *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 218 F.R.D. 408 (S.D.N.Y. 2003) (dismissing complaint concerning Doubleclick stock; putative class period Nov. 29, 1999 to Apr. 15, 2001), *appeal pending*.

The policy motivating the purchaser-seller rule in *Blue Chip Stamps* is wholly inapplicable to SLUSA. Indeed, in light of Congress' carefully crafted attempt in SLUSA to preempt those suits most subject to abuse, the Court should reject any reading of Congress' intent that would allow the most vexatious and unmeritorious holding claims (and artful pleaders) to survive or evade preemption, but that would preempt the generally more objectively verifiable claims. *See generally Clinton v. City of New York*, 524 U.S. 417, 429 (1998) (finding "no plausible reason why Congress would have intended to provide for" "special treatment of actions filed by natural persons" while precluding "entirely jurisdiction over comparable cases brought by corporate persons. Acceptance of the Government's new-found reading . . . 'would produce an absurd and unjust result which Congress could not have intended'") (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 574 (1982)).

Any such reading allowing state law holder class actions to proceed while barring purchaser class actions under state law must, moreover, be rejected under implied preemption principles because it would entirely frustrate the purposes of SLUSA. *See Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000) ("state law is naturally preempted to the extent of any conflict with a federal statute," including where the state law "'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress'") (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)); *see also Geier*, 529 U.S. at 881 (state common-law tort action that stood as an obstacle to important means-related federal objectives held preempted); *Perez v. Campbell*, 402 U.S. 637, 651-52 (1971) (state statutes that unintentionally frustrate the full effectiveness of federal law preempted).

C. Congress recognized SLUSA might foreclose some claims altogether.

Contrary to the court of appeals' supposition, there is no basis to believe that Congress intended only private securities class actions which might be brought under federal law to be preempted by SLUSA. Instead, Congress recognized when it sought to close the "federal flight loophole" through SLUSA that it might also be extinguishing altogether certain state law claims or remedies which could potentially leave investors with no effective federal or state legal recourse.

Congress adopted SLUSA's broad preemption provision over the opposition of many members of Congress, as well as witnesses and interested parties, who argued that "[p]reempting state remedies now – and requiring fraud victims to seek relief solely under the federal standards . . . could leave investors with severely limited ability to protect themselves against fraud." 144 Cong. Rec. S4797 (daily ed. May 13, 1998) (statement of Sen. Johnson).[16] In recommending in July 1998 the passage of

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16. *See also Hrg. Before the Subcomm. on Securities on S. 1260*, 105th Cong. 50 (1998) (prepared statement of Mary Rouleau, Consumer Federation of America) (SLUSA's "sweeping preemption" would "deny[] defrauded investors access to State court where most states recognize recklessness as a basis for liability, have a longer statute of limitations, and offer some form of aiding and abetting liability"); *Hrg. Before the Subcomm. on Fin. & Hazardous Mat'ls on H.R. 1689*, 105th Cong 9 (1998) (statement of Rep. Markey) ("It may well turn out that the ability to bring a class action lawsuit in State court may be the only meaningful way for some defrauded investors to recover financial losses in light of the severe, procedural, and substantive limitations established under the 1995 act. . . ."); 144 Cong. Rec. S4783-84 (letter from the Gov't Fin. Officers' Ass'n, et al. to Sen. Sarbanes) (objecting to absence of aiding and abetting liability and longer statutes of limitation and objecting to the "covered class action" definition); 144 Cong. Rec. S4787, S4794-96 (statement of Sen. Bryan) (no aiding and abetting or joint and several liability and 33 states have longer statute of limitations); *id.* at S4803-04 (statement of Sen. Cleland) (elimination of "more expansive investor protections" such as aider and abetter liability and longer statute of limitations "could be catastrophic for millions of Americans").

SLUSA over such opposition, the House Committee on Commerce stated in its concluding paragraph on "Background and Need for Legislation":

> The Committee heard testimony from opponents of the legislation, such as Ms. Mary Rouleau of the Consumer Federation of America (CFA), who testified that the bill was premature, unwarranted based on available evidence, harmful to investors, *and overly broad in its proposed preemption of State law.* The Committee believes that the overwhelming weight of the evidence available to it supports going forward with this bill at this time for the reasons previously noted.

H.R. Rep. No. 105-640, at 11 (1998) (emphasis added).

An additional dissent of Congressman Klink included with the Commerce Committee report stated of the legislation,

> I fear that the Committee is moving to cut off the state avenue for class action securities suits. That could mean that investors would have no ability to seek relief from securities wrongdoers, and that is unacceptable to me.
>
> . . . .
>
> Another question I have is, are we now saying to the states that we in Washington, DC, know better than the states what cases should go through state courts and which should not? . . . Are we next going to tell them they can't hear tobacco cases?

Id. at 52-53.[17]

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17. In fact, that is what happened next. In the Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4, Congress amended the diversity jurisdiction statute, 28 U.S.C. § 1332, to give federal courts original jurisdiction of most class action litigation, making them removable to federal court. "Covered class actions" addressed by SLUSA are specifically excluded (Cont'd)

Despite these stated concerns, Congress nevertheless chose to enact SLUSA's broad preemptive language, aware that some investors might be left without a private class action remedy and that state law protections otherwise applicable to such class actions could be entirely displaced. In so doing, Congress manifested its intent to have federal law provide a uniform substantive as well as procedural standard for covered class action claims based on misrepresentations in connection with the purchase or sale of nationally-traded securities. That policy choice should be respected.

(Cont'd)

from the diversity jurisdiction and removal provisions enacted by the Class Action Fairness Act, "to avoid disturbing in any way the federal vs. state court jurisdictional lines already drawn in the securities litigation class action context [by SLUSA]." S. Rep. No. 109-14, at 45, 49-50 (2005).

CONCLUSION

The decision of the court of appeals should be reversed in relevant part with instructions that the holder claims should be dismissed with prejudice.

Respectfully submitted,

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15 U.S.C. § 77p

§ 77p. Additional remedies; limitation on remedies

(a) Remedies additional

Except as provided in subsection (b), the rights and remedies provided by this subchapter [15 U.S.C.A. § 77a et seq.] shall be in addition to any and all other rights and remedies that may exist at law or in equity.

(b) Class action limitations

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

(1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

(2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

(c) Removal of covered class actions

Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to subsection (b).

(d) Preservation of certain actions

(1) Actions under State law of State of incorporation

(A) *Actions preserved*

Notwithstanding subsection (b) or (c), a covered class action described in subparagraph (B) of this paragraph that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

(B) *Permissible actions*

A covered class action is described in this subparagraph if it involves—

(i) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(ii) any recommendation, position, or other communication with respect to the sale of securities of the issuer that—

(I) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

(II) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

(2) *State Actions:*

(A) *In General*

Notwithstanding any other provision of this section, nothing in this section may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

(B) *State Pension Plan Defined*

For purposes of this paragraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of the State or political subdivision thereof, or by any agency or instrumentality thereof.

(3) *Actions Under Contractual Agreements Between Issuers and Indenture Trustees*

Notwithstanding subsection (b) or (c), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

(4) *Remand of removed actions*

In an action that has been removed from a State court pursuant to subsection (c), if the Federal court determines that the action maybe maintained in State

court pursuant to this subsection, the Federal court shall remand such action to such State court.

(e) Preservation of State Jurisdiction

The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

(f) Definitions

For purposes of this section, the following definitions shall apply:

(1) *Affiliate of the issuer*

The term "affiliate of the issuer" means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

(2) *Covered class action*—

(A) In general

The term "covered class action" means—

(i) any single lawsuit in which—

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an

alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

(B) Exception for derivative actions

Notwithstanding subparagraph (A), the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

(C) Counting of certain class members

For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective

class member, but only if the entity is not established for the purpose of participating in the action.

(D) Rule of construction

Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

(3) *Covered security*

The term "covered security" means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 77r(b) of this title at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall not include any debt security that is exempt from registration under this subchapter pursuant to rules issued by the Commission under section 77d(2) of this title.

15 U.S.C. § 77r(b)(1)(A)

(b) Covered securities

For purposes of this section, the following are covered securities:

(1) *Exclusive Federal Registration of Nationally Traded Securities.* A security is a covered security if such security is —

(A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the Nasdaq Stock Market (or any successor to such entities);

* * * *

15 U.S.C. § 78bb(f)

(f) Limitations on remedies

(1) *Class Action Limitations.* No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or

(B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

(2) *Removal of Covered Class Actions.* Any covered class action brought in any State court involving a covered security, as set forth in paragraph (1), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to paragraph (1).

(3) *Preservation of Certain Actions.*

(A) *Actions Under State Law of State of Incorporation*

(i) *Actions Preserved.* Notwith-standing paragraph (1) or (2), a covered class action described in clause (ii) of this subparagraph that is based upon the statutory or common law of the State in which the issuer is

incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

(ii) *Permissible Actions.* A covered class action is described in this clause if it involves—

(I) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(II) any recommendation, position, or other communication with respect to the sale of securities of an issuer that—

(aa) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

(bb) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights

(B) *State Actions*:

(i) *In General.* Notwithstanding any other provision of this subsection, nothing in this subsection may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action

involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

(ii) *State Pension Plan Defined.* For purposes of this subparagraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of a State or political subdivision thereof, or by any agency or instrumentality thereof.

(C) *Actions Under Contractual Agreements Between Issuers and Indenture Trustees.* Notwithstanding paragraph (1) or (2), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

(D) *Remand of Removed Actions.* In an action that has been removed from a State court pursuant to paragraph (2), if the Federal court determines that the action may be maintained in State court pursuant to this subsection, the Federal court shall remand such action to such State court.

(4) *Preservation of State Jurisdiction.* The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

(5) *Definitions.* For purposes of this subsection, the following definitions shall apply:

(A) *Affiliate of the Issuer.* The term "affiliate of the issuer" means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

(B) *Covered Class Action. The term "covered class action" means—*

(i) any single lawsuit in which—

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

(C) *Exception for Derivative Actions.* Notwithstanding subparagraph (B), the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

(D) *Counting of Certain Class Members.* For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.

(E) *Covered Security.* The term "covered security" means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933 [15 U.S.C.A. § 77r(b)], at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall

not include any debt security that is exempt from registration under the Securities Act of 1933 [15 U.S.C.A. § 77a et seq.] pursuant to rules issued by the Commission under section 4(2) of that Act [15 U.S.C.A. § 77d(2)].

(F) *Rule of Construction.* Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

* * * *

Sec. 102 Promotion of Reciprocal Subpoena Enforcement

(a) Commission Action. — The Securities and Exchange Commission, in consultation with State securities commissions (or any agencies or offices performing like functions), shall seek to encourage the adoption of State laws providing for reciprocal enforcement by State securities commissions of subpoenas issued by another State securities commission seeking to compel persons to attend, testify in, or produce documents or records in connection with an action or investigation by a State securities commission of an alleged violation of State securities laws.

(b) Report. — Not later than 24 months after the date of enactment of this Act, the Securities and Exchange Commission (hereafter in this section referred to as the "Commission") shall submit a report to the Congress—

(1) identifying the States that have adopted laws described in subsection (a);

(2) describing the actions undertaken by the Commission and State securities commissions to promote the adoption of such laws; and

(3) identifying any further actions that the Commission recommends for such purposes.

15 U.S.C. § 78j

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

17 C.F.R. § 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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SUPREME COURT, U.S.

No. 04-1371

IN THE
Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Petitioner,

v.

SHADI DABIT, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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December 19, 2005

QUESTION PRESENTED

Whether the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preempts claims brought by holders of securities based upon misrepresentations, omissions, or manipulation, notwithstanding SLUSA's language limiting preemption to claims "in connection with the purchase or sale of a covered security," and this Court's interpretation of identical language to cover only claims brought by purchasers or sellers in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

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For more than a century, investors have brought claims under state law when a defendant's unlawful acts or omissions induced them to hold securities. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), this Court recognized that such holder claims cannot be brought by investors under § 10(b) and Rule 10b-5, because those investors' injuries were not suffered "in connection with the purchase or sale" of securities. In the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Congress adopted § 10(b)'s "in connection with" phraseology to preempt the class of private actions that could have been brought as federal securities suits but were being asserted under state law ostensibly to evade the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). By the language it chose, the debates it conducted, the doctrine it incorporated, and the history against which it legislated, Congress expressed no intent to extinguish an entire class of investors' claims.

Yet that is precisely what petitioner and its *amici* ask this Court to hold. SLUSA, however, was not designed to extinguish any claims at all. Rather, its purpose was to re-channel from state court to federal court those purchaser-seller claims traditionally brought under federal law and to ensure that such claims could only be brought under the heightened pleading requirements of federal law. Congress expressed no intent – in the language of SLUSA or otherwise – to expand the Act's preemptive scope to an entirely new class of cases that were not cognizable under the federal securities laws. This Court has consistently refused to confer complete immunity on businesses for wrongs recognized under state law absent a clear expression of intent by Congress. Given the well-chronicled abuses in the securities industry, this Court should not infer that Congress intended to leave those injured the most in the aggregate – the smallest investors who practically can seek redress only by banding together in a class action – without any remedy for harms in connection with their holding of securities.

STATEMENT

1. More than 150 years ago, the States initiated the first efforts to ensure the integrity of this country's financial markets. *See* 1 Louis Loss & Joel Seligman, *Securities Regulation* 31-43 (3d ed. 1998) ("Loss & Seligman"); Gerald D. Nash, *Government and Business: A Case Study of State Regulation of Corporate Securities, 1850-1933*, 38 Bus. Hist. Rev. 144, 144-52 (1964) ("Nash"); Louis Loss & Edward M. Cowett, *Blue Sky Law* 3-17 (1958) ("Loss & Cowett"). State supervision of the securities industry began as an aspect of the States' traditional regulation of corporations and other business associations. As the number of corporations increased in the middle of the nineteenth century, States responded by passing targeted legislation directly regulating certain types of issuers of securities. *See* Nash at 148-49; 1 Loss & Seligman at 31-32. In 1911, Kansas passed the first "comprehensive licensing system" for the securities industry, one of many state statutes now referred to as "Blue Sky Laws." *See* Loss & Cowett at 7-9. By 1933, every State but one had enacted such a statute. *See* Loss & Cowett at 10; 1 Loss & Seligman at 40; *see also* Nash at 150-52.

"In the wake of the 1929 stock market crash and in response to reports of widespread abuses in the securities industry," Congress passed "two landmark pieces of securities legislation": the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"). *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 170 (1994). Recognizing that the States, because of jurisdictional impediments and resource deficiencies, lacked the ability to ensure the optimal level of disclosure, *see* 1 Loss & Seligman at 146-51, 219, Congress in the 1933 and 1934 Acts instituted a national regime of mandatory corporate disclosure. Section 10(b), the general antifraud provision of the 1934 Act, makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined

in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission ("SEC")] may prescribe." 15 U.S.C. § 78j(b). In 1942, the SEC adopted Rule 10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. This Court has implied a private right of action from those provisions. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 & n.9 (1971). Under that right of action, a plaintiff must allege that the defendant's fraudulent conduct was in connection with her own purchase or sale of a security. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

When Congress entered the field of securities regulation in 1933 and 1934, it chose not to displace the existing state systems of securities regulation. The 1933 and 1934 Acts each explicitly preserved applicable state law. *See* 1933 Act § 16, 48 Stat. 74, 84; 1934 Act § 28, 48 Stat. 881, 903. Additionally, "far from preempting the field when interstate commerce is involved, Congress affirmatively yielded to local regulation by inserting a number of intrastate exemptions even when the mails or facilities of interstate commerce are used." 1 Loss & Seligman at 41.

The States have continued their traditional role of protecting investors. "Today all 50 states, the District of Columbia, Guam, and Puerto Rico have blue sky laws in force," with most having adopted the Uniform Securities Act of 1956 and several more the Revised Uniform Securities Act of 1985. *Id.* at 41-42. State statutes and common law provide significant private remedies for investors harmed by fraud and other misconduct. *See* 9 *id.* at 4114-66. "Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions." *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 383 (1996).

For at least a century, state law has permitted recovery by investors who have suffered losses in the value of their stock holdings from misconduct. Shareholders have sought recovery for injuries sustained when they were induced by misrepresentations to refrain from selling their securities.[1] Judge Friendly, for example, applied long-

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[1] *See, e.g.*, *Small v. Fritz Cos.*, 65 P.3d 1255, 1259 (Cal. 2003) (refusing to make exception to "the principle that induced forbearance can be the basis for tort liability" for "lawsuits involving misrepresentations affecting corporate stock"); *Ward v. Atlantic Sec. Bank*, 777 So. 2d 1144, 1146 (Fla. Dist. Ct. App. 2001) (reversing entry of summary judgment against investor who alleged that his stockbroker fraudulently persuaded him to change his mind about selling shares in a fund); *David v. Belmont*, 197 N.E. 83, 83-85 (Mass. 1935) (affirming judgment for plaintiff on a count alleging that defendants had fraudulently induced him to hold stock); *Continental Ins. Co. v. Mercadante*, 225 N.Y.S. 488, 490-91 (N.Y. App. Div. 1927) (holding that plaintiffs had stated cognizable claim for relief by alleging that defendant fraudulently induced them to hold securities); *Fottler v. Moseley*, 60 N.E. 788, 788-89 (Mass. 1901) (rejecting argument that plaintiff could not recover for fraud that had caused him to decide not to sell his stock because he did not take action in reliance on fraudulent statements); *see also Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 407 (S.D.N.Y. 2005) ("The elements of common law fraud [under New York law] thus are largely the same as those of a Rule 10b-5 claim except that there is no requirement that the fraud be 'in connection with the purchase or sale of securities.' In other words, a claim for common law fraud is available to investors who retain their securities in reliance on a defendant's misrepresentations.") (footnote omitted); *Rogers v. Cisco Sys., Inc.*, 268 F. Supp. 2d 1305, 1311 n.13 (N.D. Fla. 2003) (stating

standing New York law to approve a class-action settlement that included state-law holder claims and referred to "the rule of New York law whereby persons who merely held [the company's] securities would have been permitted to show reliance by proving that defendants' alleged misrepresentations and nondisclosures caused them to hold securities they would otherwise have sold." *Weinberger v. Kendrick*, 698 F.2d 61, 78 (1982) (citing *Continental Ins.*, 225 N.Y.S. 488), *modified on reh'g*, 698 F.2d 81 (2d Cir. 1983). In addition to claims of fraud and misrepresentation, investors have brought claims under state law seeking recovery for breaches of fiduciary duty causing decreases in the value of their investments.[2] Finally, some

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that Florida common law permits holders of securities to recover for fraud and negligent misrepresentation); *Gutman v. Howard Sav. Bank*, 748 F. Supp. 254, 261-67 (D.N.J. 1990) (recognizing that, "under New York law, a plaintiff may state a common law fraud claim against a defendant whose misrepresentations caused plaintiff to hold securities that plaintiff otherwise would have sold" and predicting that New Jersey Supreme Court would similarly permit investors to recover under common law for harm caused by fraud and negligent misrepresentation); *Abelson v. Strong*, 644 F. Supp. 524, 532 (D. Mass. 1986) (citing *Holloway v. Forsyth*, 115 N.E. 483 (Mass. 1917), for proposition that "[a] direct purchaser-seller relationship . . . is not necessary [to state a claim for securities fraud] at common law"); *Boykin v. Arthur Andersen & Co.*, 639 So. 2d 504, 506-07 (Ala. 1994) (reversing dismissal of fraud claims by shareholders who alleged that corporate officers and directors of company and the company's auditors misled them regarding company's financial condition); *Manzo v. Rite Aid Corp.*, No. 18451-NC, 2002 Del. Ch. LEXIS 147, at *2, *9-*10, *14 (Del. Ch. Dec. 19, 2002) (indicating holder of securities could state actionable fraud claim), *aff'd*, No. 23, 2003, 2003 Del. LEXIS 303 (Del. May 29, 2003); *cf. Twin Fires Inv., LLC v. Morgan Stanley Dean Witter & Co.*, No. 00-00751-F, 2002 WL 31875204, at *29 (Mass. Super. Ct. Dec. 16, 2002) ("[t]he common law of fraudulent misrepresentation does protect potential buyers of securities"); *Little Beaver Creek Valley R.R. & Hist. Soc., Inc. v. P.L. & W.R.R.*, No. 95-C0-76, 1998 Ohio App. LEXIS 2657, at *14-*15 (Ohio Ct. App. June 10, 1998) (upholding jury verdict for plaintiffs fraudulently induced by attorney not to purchase stock in corporation).

[2] *See Ward*, 777 So. 2d at 1147 (reversing entry of summary judgment against investor who alleged that his stockbroker breached its duty of loyalty and care in fraudulently persuading him to change his mind about selling shares in fund); *Rogers*, 268 F. Supp. 2d at 1314-15

state statutes provide remedies for defrauded investors without requiring those investors to have purchased or sold securities in connection with the fraud.[3]

2. In 1995, Congress passed the PSLRA (codified in part at 15 U.S.C. §§ 77z-1, 78u) to prevent "strike suits," or meritless class actions alleging fraud in the securities market brought to extract settlements from companies seeking to avoid a costly legal proceeding. *See* H.R. Conf. Rep. No. 105-803, at 13 (1998). To deter those suits, the

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(allegation that company's officers "engaged in various conduct in an effort to disguise or misrepresent [the company's] earnings to induce its shareholders to retain their stock" stated claim for breach of fiduciary duty under California law); *see also Fraternity Fund*, 376 F. Supp. 2d at 409-10 (concluding that investors in hedge funds had stated claims under New York law for breach of fiduciary duty against managers who allegedly misrepresented funds' values); *Malone v. Brincat*, 722 A.2d 5, 9, 13 (Del. 1998) ("directors who knowingly disseminate false information that results in . . . damage to an individual stockholder violate their fiduciary duty"; "[h]ere, it is to be noted, the claim appears to be made by those who did not sell and, therefore, would not implicate federal securities laws which relate to the purchase or sale of securities"); *cf. Estate of Rains v. Krause*, 803 P.2d 1060 (Kan. Ct. App. 1991) (table) (holding that plaintiff stated claim upon which relief could be granted by alleging that majority shareholder misled other shareholders to decline offer to buy their stock).

[3] *See Ward*, 777 So. 2d at 1146-47 (since 1992, the Florida Securities and Investors Protection Act has provided a cause of action for fraud "in connection with the rendering of any investment advice"); *see also* D.C. Code §§ 31-5605.02(a)(1), 31-5606.05(a)(3)(A) (2005) (providing for cause of action against one who commits fraud "[i]n connection with the rendering of investment advice"); Idaho Code Ann. §§ 30-14-502(a), 30-14-509(f) (2004) (enacting provisions of Uniform Securities Act of 2002 that impose civil liability for provision of fraudulent investment advice); Iowa Code §§ 502.502, 502.509(6) (2004) (same); 2004 Kan. Sess. Laws ch. 154, §§ 31(a), 38(f) (enacted May 17, 2004) (same); 2005 Me. Legis. Serv. ch. 65 (H.P. 384, L.D. 509) (West) (to be codified at Me. Rev. Stat. Ann. tit. 32, §§ 16502(1), 16509(6)) (same); Mo. Rev. Stat. §§ 409.5-502(a), 409.5-509(f) (2005) (same); Okla. Stat. tit. 71, §§ 1-502(A), 1-509(F) (2005) (same); 2005 S.C. Acts No. 110 (to be codified at S.C. Code Ann. §§ 35-1-502(a), 35-1-509(f)) (same); S.D. Codified Laws §§ 47-31B-502(a), 47-31B-509(f) (2005) (same); 2005 Vt. Acts & Resolves No. 11 (to be codified at Vt. Stat. Ann. tit. 9, §§ 5502(a), 5509(f)) (same); V.I. Code Ann. tit. 9, §§ 652(a), 659(f) (2005) (same).

PSLRA imposed stringent pleading and other procedural requirements on securities class-action plaintiffs.

Three years after the PSLRA was enacted, Congress found that an increased number of plaintiffs were bringing suit against issuers in state court alleging securities fraud under state statutory or common law. *See* SLUSA, Pub. L. No. 105-353, §§ 2(2), 2(5), 112 Stat. 3227, 3227. To prevent plaintiffs from evading the PSLRA by bringing state-law claims in state court that they could have brought in federal court under federal law, Congress passed SLUSA, which amended the 1933 and 1934 Acts to preclude certain class actions under state law as follows:

> No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging –
>
> (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1).[4] SLUSA defines a "covered class action" as a suit for damages brought by more than 50 people, but excludes derivative actions from that definition. *See id.* § 78bb(f)(5)(B)-(C). Additionally, SLUSA exempts from preemption certain suits that might otherwise have been held to fall within the statute's preemptive scope – for example, class actions by States and their political subdivisions. *See id.* § 78bb(f)(3)-(4).

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[4] That preemption provision comes from SLUSA's amendment to the 1934 Act. It is "functionally identical" to the preemption provision added by SLUSA to the 1933 Act, 15 U.S.C. § 77p(b). *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 481 (7th Cir.), *petition for cert. pending*, No. 05-409 (U.S. filed Sept. 29, 2005). For convenience, this brief henceforth refers only to the 1934 Act preemption provision.

3. For years, investors have been harmed by a number of trading practices involving manipulation of the securities markets. Two particular abuses – the provision of misleading long-term "buy" or "hold" ratings by investment advisors and the failure of mutual funds to check a practice known as "market timing" – have been uniquely harmful to holders of securities, including the millions of Americans who invest a portion or all of their long-term savings in the stock market.[5]

a. ***Biased investment advice.*** Investment advisors provide clients with detailed assessments of specific securities. Those analyses typically include recommendations, such as "buy" or "sell," based on the current and anticipated performance of the security. *See, e.g.*, Pet. Br. 12.

A number of investment advisors, including those employed by Merrill Lynch, have been accused of issuing misleading research reports throughout the 1990s and into the early part of this decade in an effort to secure investment banking business.[6] Investment companies, like Merrill Lynch, tied analyst salaries to the company's gen-

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[5] Approximately 91.1 million American investors own individual securities or mutual funds, with the average American household holding approximately $65,000 in these securities. More than $4 trillion of these holdings are invested in mutual funds. *See* Investment Company Institute & Securities Industry Ass'n, *Equity Ownership in America, 2005* (2005); Investment Company Institute, *2005 Investment Company Fact Book* (2005); Financial Policy Forum, *Special Policy Brief 13 – Overview of Mutual Fund Scandal: "A Gauntlet of Fraud"*, at *3 (Dec. 14, 2003; updated May 21, 2004).

[6] *See, e.g.*, Conal Walsh, *Joe Public takes on giants of Wall Street*, The Observer (Apr. 14, 2002) (relating allegations that Jack Grubman, the "superstar" analyst for Salomon Smith Barney, and Henry Blodget, the "star analyst" for Merrill Lynch, issued misleading analyses of several companies to secure additional banking business); Rebecca Byrne, *Of Bubble Triumvirate, Only Meeker Remains*, TheStreet.com (Aug. 20, 2002). *See also* SEC Litigation Release No. 18117 (Apr. 28, 2003) (announcing details of SEC settlement with Morgan Stanley for the alleged provision of biased investment advice to clients); SEC Litigation Release No. 18116 (Apr. 28, 2003) (same, for Lehman Brothers); SEC Litigation Release No. 18115 (Apr. 28, 2003) (same, for Merrill Lynch and Henry Blodget).

eration of such business.[7] That compensation scheme provided advisors with an incentive to issue unduly optimistic public evaluations of those companies targeted for lucrative investment banking contracts.

In 2002, New York's Attorney General charged Merrill Lynch with engaging in a pattern of supplying biased advice to investor clients in exchange for investment banking work that yielded considerable fees.[8] Alhough Merrill Lynch's analysts privately believed that stock in certain companies was "crap," a "dog," or "going a lot lower," the analysts continued to recommend those stocks to clients and to the public to attract and retain investment banking business.[9] Indeed, although Merrill Lynch internally classified at least one stock as a "piece of junk," it publicly gave that stock the highest possible quality rating.[10] And at least one Merrill Lynch analyst was fined $225,000 and suspended for one year by the National Association of Securities Dealers ("NASD") after issuing misleadingly favorable reports on the prospects of Merrill Lynch's investment banking clients, while internally predicting that the clients would soon suffer substantial losses when "the debt bomb starts to TICK, TICK, TICK."[11] Merrill Lynch's own analysts recognized the harms that such practices

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[7] *See* Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcomm. on Capital Markets, Insurance, & Government Sponsored Enterprises of the House Comm. on Financial Services, 107th Cong. (July 31, 2001) (Statement of Laura S. Unger, Acting Chair, SEC) (explaining that firms pay analysts based on the profitability of investment banking units, which created conflicts of interest).

[8] *See, e.g.*, Office of New York State Attorney General Eliot Spitzer, *Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest* (Apr. 8, 2002).

[9] *See* http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf, at 10-11, 13 (visited Dec. 16, 2005).

[10] *Id.* at 12, 13.

[11] *See* National Association of Securities Dealers, *NASD Fines and Suspends Phua Young, Former Merrill Lynch Research Analyst* (May 25, 2004).

inflicted on the long-term holders of securities. As one analyst pressured to give a "buy" rating to a poor investment stated: "I don't think it is the right thing to do. John and Mary Smith are losing their retirement because we don't want a client's CEO to be mad at us."[12]

Many long-term investors have asserted that they relied to their detriment on biased advice from stock analysts. For example, investors have alleged that they decided, based on specific conversations with investment advisors or on their stock ratings, to hold securities for far longer than they otherwise would have. Merrill Lynch paid at least one former client $400,000 to settle allegations that its misleading research caused more than $800,000 in damages to the client, who held overvalued securities in reliance on Merrill Lynch's biased investment advice.[13] In addition, Merrill Lynch publicly apologized to its clients, shareholders, and employees for its investment advisors' behavior.[14] And, as part of a settlement with the SEC and New York, Merrill Lynch agreed (1) to pay more than $125 million in fines and restitution; (2) to disclose to its clients and the public when it makes an investment recommendation concerning a particular security whether it has received in the past 12 months, or is then entitled to, any compensation from the company being analyzed; (3) to establish an independent monitor for ensuring compliance

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[12] Office of New York State Attorney General Eliot Spitzer, *Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest* (Apr. 8, 2002).

[13] *See* Rachel Beck, *Merrill pays $400,000 to tech-battered investor; Settlement follows SEC warnings and trade group guidelines*, Hamilton Spectator, July 21, 2001, at B2. That investor, Debasis Kanjilal, spoke to his Merrill Lynch advisor daily and repeatedly expressed his desire to sell two poorly performing stocks. The advisor, noting that the company still gave these securities a "buy" rating, told Kanjilal to "sit tight" and hold them. Only when the value of the stocks was close to nothing did Merrill Lynch eventually downgrade its analysis and encourage clients, including Kanjilal, to sell. *See id.*

[14] *See, e.g.*, Anthony Mason, *Merrill Admits to Wrong Kind of Bull*, CBSNews.com (Apr. 26, 2002) (quoting apology of Merrill Lynch).

with these new policies; and (4) to change significantly its compensation and evaluation methods for analysts.[15]

b. ***Market timing.*** Another type of injury suffered uniquely by investors who hold, but do not trade in, securities stems from the management of mutual funds, such as those of Merrill Lynch.[16] Mutual funds are open-ended funds that invest in a number of assets.[17] Millions of American households have purchased shares of mutual funds and, in so doing, have entrusted $4 trillion in long-term savings to the investment companies that manage the funds.[18] Although mutual funds are "a vital part of this nation's economy" and the investment vehicle on which "[m]illions of investors depend . . . for their financial security,"[19] they have been plagued with problems. Between 1996 and 2001, the average fund-holding American family lost approximately $3,740 in long-term savings to several forms of market manipulation and trading abuse.[20] Among the practices inflicting those losses has been a trading strategy known as "market timing."

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[15] *See* SEC Litigation Release No. 18117 (Apr. 28, 2003) (outlining details of $125 million in payments); Office of New York State Attorney General Eliot Spitzer, *Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices* (May 21, 2002) (recounting numerous changes to Merrill Lynch's system of compensating and evaluating its analysts).

[16] *See* Merrill Lynch, *Mutual Funds at Merrill Lynch, at* http://askmerrill.ml.com/publish/marketing_centers/products/inv028_MutualFundsatMerrillLynch/ (last visited Dec. 16, 2005).

[17] *See* http://www.sec.gov/investor/tools/mfcc/mutual-fund-help.htm (Oct. 17, 2005).

[18] *See* Financial Policy Forum, *Special Policy Brief 13 – Overview of Mutual Fund Scandal: "A Gauntlet of Fraud"*, at *3.

[19] *Mutual Fund Trading Abuses: Hearing Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary*, 109th Cong. 37 (2005) (Statement of Lori A. Richards, Director, SEC's Office of Compliance Inspections and Examinations) ("2005 House Hearing").

[20] *See* Financial Policy Forum, *Special Policy Brief 13 – Overview of Mutual Fund Scandal: "A Gauntlet of Fraud"*, at *2.

Market timing is the purchase and sale of a mutual fund's shares in a manner that exploits differences between the calculated value and the actual value of those shares. Most mutual funds calculate the value of their entire portfolio (commonly referred to as the Net Asset Value, or "NAV") only once per day, typically at the 4:00pm close of trading on New York exchanges. The NAV is ordinarily calculated by valuing each fund-owned asset using the final price at which it traded on its native exchange that day. For assets listed on the New York exchanges, that method supplies an up-to-date asset price.[21] But for assets listed on foreign exchanges, some of which may have closed as many as 15 hours beforehand, that approach creates a window for arbitrage. Because the NAV is calculated using the closing price of each asset, and not its real-time value based on information revealed after the close of trading on the asset's native exchange, the fund will often give its portfolio an artificially high or low value. Stale information used to calculate the NAV thus creates opportunities to purchase or sell fund shares at an immediate profit.[22]

Long-term holders of mutual fund shares bear the costs of market timing, not the purchasers or sellers of a fund's shares. When an outdated NAV causes a fund to value its shares at an artificially low price, market timers will buy the mutual fund and receive a greater ownership stake in

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[21] An exception to this rule involves relatively illiquid assets, such as small-cap stocks or high-yield bonds, which may not trade often (if at all) in a given trading day. Because an illiquid security may not trade for many hours prior to the close of the New York exchange, the price at which that asset last traded may be significantly outdated and may lead to an artificially low or high NAV, which creates arbitrage opportunities. *See, e.g.*, Richard L. Levine, Yvonne Cristovici & Richard A. Jacobsen, *Mutual Fund Market Timing*, Fed. Lawyer, Jan. 2005, at 30.

[22] This time-zone arbitrage problem has been explained as follows: "[s]tock of a Japanese firm that closes in Tokyo at ¥10,000 might trade in Frankfurt at € 75.22 (equivalent to ¥10,500) between the close in Tokyo and the close in New York – but the mutual fund nonetheless would value each share at ¥10,000, because that was its most recent price in the issuer's home market." *Kircher*, 403 F.3d at 480.

the fund than if the NAV had been accurately calculated. Hence, purchasing market timers dilute the existing shares' value in the fund. Similarly, when an outdated NAV causes the fund to value its shares at an artificially high price, market timers will sell the mutual fund and receive a greater price for that sale than an NAV based on up-to-date information. Accordingly, selling market timers deplete the pooled assets of the fund's investors. In either scenario, the parties harmed by market timing are those who held their shares while others purchased or sold. While a mutual fund's use of stale prices may also cause a purchaser to buy a fund share at an artificially high price, or a seller to redeem a share at an artificially low price, those losses do not depend on whether other individuals simultaneously engage in market timing.

Throughout the 1990s, mutual funds began to increase trading fees and implement restrictions on "quick in – quick out" trades of the sort required for market timing.[23] But those efforts did little, if anything, to stem the tide of losses ebbing from legitimate investors' holdings. Timers immediately began to form side agreements with fund managers and investment company employees. Under those agreements, timers provided considerable fixed assets to funds in exchange for the ability to make large-capacity transactions, despite fund policies that discouraged or restricted such trades.[24] Even while funds publicly claimed to be eliminating opportunities for timing,

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[23] *See* Peter Elkind, *The Secrets of Eddie Stern*, Fortune, Apr. 19, 2004, at 106, 114; Levine, Cristovici & Jacobsen, *Mutual Fund Market Timing* at 30.

[24] *See* 2005 House Hearing at 40 (Richards Statement) ("It is important to note that the illegal market timing involved secret arrangements between fund executives and select market timers allowing the timers to engage in more frequent trading than the fund's prospectus or other internal policies allowed. Some of the arrangements involved nominee accounts and false trading records. These were covert, non-disclosed arrangements. In fact, many fund firms stated at the time that they deterred market timers, and had even hired 'market timing police' to prevent this type of trading.").

these quid-pro-quo agreements between market timers and fund managers were rampant within the mutual fund industry and wreaked substantial damage on investors.[25] John Bogle, founder and former CEO of the Vanguard Group, estimated that a combination of market timing and illegal late trading[26] costs long-term holders of mutual fund shares between $5 and $10 billion annually.[27]

4. Until details of the investment companies' provision of biased investment advice and the mutual funds' complicity in the manipulative practice of market timing became public knowledge, the SEC did not undertake significant rulemaking or enforcement action to combat those problems. The SEC and other regulators had long ago obtained evidence of bias in investment advice.[28] They also

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[25] *See* Elkind, *Secrets of Eddie Stern* at 122 ("Clearly, by 2001 everyone connected with the fund industry had to know how crooked the business had become. . . . Everyone seemed to know, that is, except the buy-and-hold investors in mutual funds, and the SEC, which appeared to be clueless. 'I don't think there's anyone at the agency who doesn't wish the agency had been more attuned to this problem before it came to light,' says chagrined SEC enforcement director Steven Cutler.").

[26] *See id.* ("[A]fter the scandal broke, the SEC surveyed the 88 largest fund companies and discovered, stunningly, that half admitted to allowing market timing – and 25% allowed late trading.").

[27] *See, e.g.*, Jennifer Barrett, "Inexcusable," MSNBC.com, Nov. 11, 2003 (interview with Bogle, estimating market-timing dilution to cost investors $5 to $10 billion per year). *See also* Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. Econ. & Org. 245, 260 (2003) ("total annualized dilution in the first three quarters of 2001 can be estimated at $4.9 billion per year").

[28] *See, e.g.*, Hsiou-wei Lin & Maureen F. McNichols, *Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations*, 25 J. Acct. & Econ. 101 (1998) (concluding that investment analysts provided significantly more favorable analysis when examining securities offered by companies that the analysts' employer was partially or solely underwriting). In 1996, the *Wall Street Journal* reported "significant evidence of bias and possible conflict of interest" in analysts' recommendations. *See* Roger Lowenstein, *Today's Analyst Often Wears Two Hats*, Wall St. J., May 2, 1996, at C1. A few years later, the same paper reported that more than 99 out of every 100 analyst recommendations were a "buy" or "hold" of some shade, while less than 1% recommended a sale of any security. *See* John Hechinger,

knew, since at least 1981, of market timing and the dangers that it posed.[29] But regulators took no meaningful action to correct those problems before 2003.[30]

5. a. In April 2002, before the SEC took action, Dabit, a former Merrill Lynch broker, filed this suit in federal court. He alleged, on behalf of himself and others similarly situated (including current and former Merrill Lynch brokers), that Merrill Lynch willfully distorted its stock

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Heard in New England: Analysts May Hate to Say "Sell," But a Few Companies Do Hear It, Wall St. J., Apr. 8, 1998, at NE2.

[29] *See In re Putnam Int'l Equities Fund, Inc. (No-Action Letter)*, Fed. Sec. L. Rep. ¶ 76,816, 1981 WL 25522, at *4 (SEC Feb. 23, 1981) (opining that investment firm would not face liability for standard NAV policies, so long as more up-to-date information was used to value foreign securities following an "extraordinary event"). *See also Pricing of Redeemable Securities for Distribution, Redemption, and Repurchase*, SEC Release No. IC-14244, 49 Fed. Reg. 46,558, at n.7 (Nov. 21, 1984) (noting the problems of time-zone arbitrage but declining to establish standards governing fund management of market timers).

[30] Despite "abundant evidence that something was seriously amiss in the world of equity analysts," there were "no significant rulemaking" efforts by the SEC or the NASD, and "no major enforcement actions" attempting to address the apparent bias until 2003, long after many state and federal plaintiffs began to assert their rights. *See* Barbara Moses, *The "Discovery" of Analyst Conflicts on Wall Street*, 70 Brook. L. Rev. 89, 97 (2004). No significant attempts to combat market timing occurred until 2004, when the SEC finally engaged in rulemaking to address the harms of market timing by requiring that funds disclose their anti-timing policies to investors. *See Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, 69 Fed. Reg. 22,300 (Apr. 23, 2004) (to be codified at 17 C.F.R. Pts. 239, 274). A General Accounting Office ("GAO") probe found "information that was available prior to September 2003 and that was inconsistent with SEC staff's views that market timing was a low-risk area because companies would necessarily act to protect fund returns from the harmful consequences of frequent trading." 2005 House Hearing at 16 (Statement of Richard J. Hillman, GAO, Director of Financial Markets and Community Investment). The GAO noted, for example: "[A] mutual fund company insider provided information to an SEC district office in early 2003 indicating that a company had poor market timing controls, but the office did not act promptly on this information. If the SEC office had acted on this tip in early 2003, it might have identified potentially illegal market timing activity by company insiders." *Id.* at 16-17.

recommendations and breached both the covenant of good faith and fair dealing implied in the brokers' employment contracts and its fiduciary duty to its brokers. Dabit sought to recover for two types of damages incurred between December 1, 1999, and December 31, 2000: (1) holding damages resulting from the brokers' reliance on Merrill Lynch's willfully inaccurate recommendations, which allegedly caused Dabit and the other brokers to hold onto securities that were poor investments; and (2) lost fees, as some clients harmed by Merrill Lynch's biased investment recommendations subsequently closed their accounts with the brokers. *See* JA 28a.

The district court ruled that Dabit's complaint was preempted by SLUSA and dismissed the case without prejudice, explaining that Dabit could file an amended complaint pleading "claims based on wrongfully-induced holding." JA 49a. Dabit filed an amended complaint, which defined the class as including those brokers who "owned and continued to own one or more of the [Merrill Lynch] recommended securities . . . or recommended such securities to their clients during the period from December 1, 1999 through December 31, 2000 . . . and who suffered damages as a result of owning and holding such [Merrill Lynch] Stocks during this time period." JA 52a (¶ 1). The new class definition also included those brokers "who suffered damages as a consequence of the loss of clients due to [Merrill Lynch's] wrongful actions." *Id.*

b. Dabit's complaint was transferred, along with more than 120 others, to the Southern District of New York by the Judicial Panel on Multidistrict Litigation ("JPML"). Following transfer, Merrill Lynch again moved to dismiss Dabit's complaint under Rule 12(b)(6) as preempted by SLUSA. The court dismissed Dabit's suit with prejudice. The court determined that the holding and lost-fee claims in Dabit's amended complaint were "based on the very same alleged series of transactions and occurrences asserted" in other federal securities actions consolidated before the court by the JPML. Pet. App. 55a. Thus, the

court concluded that Dabit's claims fell "squarely within SLUSA's ambit." *Id.*

c. The Second Circuit partially reversed. It consolidated Dabit's appeal with another to address "whether [SLUSA] . . . preempts claims that do not allege that putative class members purchased or sold particular securities in reliance upon the defendant's alleged misconduct." Pet. App. 2a. Recognizing that Congress borrowed SLUSA's "in connection with" language from § 10(b) of the 1934 Act and SEC Rule 10b-5, the court determined that SLUSA's "in connection with" requirement must be read in light of *Blue Chip Stamps*, which held that plaintiffs proceeding under the implied right of action to enforce § 10(b) and Rule 10b-5 must have themselves bought or sold in connection with the alleged misconduct. The court concluded that SLUSA does not preempt the claims of non-transacting plaintiffs, explaining that this interpretation comports with the Act's stated goal of closing the "federal flight" loophole in the PSLRA. Although the Second Circuit recognized that "[t]he limitation on standing to bring private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities," *id.* at 27a, it found that observation to have "little persuasive force in this context, because SLUSA deals with precisely the category of actions subject to the purchaser-seller rule," *id.* at 28a.

The court of appeals then elaborated on the category of claims that SLUSA does not cover. It cautioned that "a plaintiff who alleges the purchase and retention of securities in reliance on the misrepresentation but who forswears *damages* from the purchase and seeks only 'holding damages' has still run afoul of SLUSA, which by its plain terms preempts claims 'alleging' fraud in connection with the purchase or sale, and not merely claims seeking damages specifically traceable to the initial purchase." *Id.* at 39a. The court explained that, to state a non-preempted holder claim based on the fraud-induced reten-

tion of securities, a plaintiff must plead that she "purchased stock independent of any misrepresentation but was induced to retain it by a material misrepresentation or omission." *Id.* at 37a.

Examining Dabit's amended complaint, the court of appeals noted that the class definition failed to distinguish between brokers who purchased in reliance on Merrill Lynch's investment advice and those who bought Merrill Lynch-recommended securities before any relevant misrepresentation. *See id.* at 40a-43a. Because the complaint did not permit the court to identify the claims of brokers who bought in connection with the alleged fraud (which are preempted) and those of brokers who only held in connection with the claimed misconduct (which are not preempted), the Second Circuit agreed with the district court that Dabit's amended complaint must be dismissed under SLUSA. *See id.* at 40a, 43a. But the court held that the dismissal should have been without prejudice. *See id.* at 43a. Accordingly, the court vacated the dismissal with prejudice and remanded this case to the district court to give Dabit the opportunity to file an amended complaint alleging non-preempted holder claims. *See id.*[31]

As the case comes to this Court, there is no active complaint. The question presented is whether SLUSA preempts every conceivable state-law claim for damages that could be brought by a non-transacting private securities plaintiff such as Dabit.

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[31] The court of appeals also held that Dabit's claim for lost fees was not preempted because that claim, "by its very nature, does not allege fraud that 'coincide[s]' with the sale or purchase of a security." Pet. App. 44a (citing *SEC v. Zandford*, 535 U.S. 813, 825 (2002)). Merrill Lynch has not sought this Court's review of that ruling.

SUMMARY OF ARGUMENT

A private plaintiff alleging that a defendant's bad acts caused a decrease in the value of an investment has not "alleg[ed]" wrongdoing "in connection with the purchase or sale of a covered security" under SLUSA, unless the plaintiff also alleges that the defendant's misstatements or omissions were made in connection with the plaintiff's purchase or sale. That interpretation of SLUSA flows from the text of the statute, accords with this Court's presumption against preemption, fulfills Congress's purpose in enacting SLUSA, and is necessary to ensure the integrity of the Nation's securities markets.

First, in private securities litigation under § 10(b) and Rule 10b-5, the phrase "in connection with the purchase or sale" has a settled judicial interpretation: A private party does not assert a claim "in connection with the purchase or sale of any security" within the meaning of § 10(b) and Rule 10b-5 unless that party avers that the defendant's act or omission was in connection with her own purchase or sale. *See Blue Chip Stamps*, 421 U.S. at 730-31, 749. Congress incorporated that interpretation of § 10(b) and Rule 10b-5 when it used the same language while legislating in the context of private securities litigation. *Blue Chip Stamps* and the Second Circuit opinion on which that decision was based – *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) – make clear that the purchaser-seller rule derives from the phrase "in connection with the purchase or sale" in § 10(b) and Rule 10b-5. SLUSA applies solely to private suits for damages and should be interpreted in accordance with this Court's cases construing § 10(b) and Rule 10b-5 in such suits.

Second, this Court presumes that Congress does not intend to preempt traditional state-law causes of action. The States have regulated the securities industry for more than 150 years, and investors have brought state-law holder claims for more than a century. Petitioner and its *amici* exaggerate the need for uniformity in the securities

industry, which provides no warrant for disregarding the traditional presumption against preemption.

Third, Congress's purpose, as evidenced by the legislative history, was to preempt only those claims that could have been brought under federal law. Congress enacted SLUSA to prevent plaintiffs from evading heightened federal pleading requirements by filing such claims in state court under the guise of state law. Congress intended to secure a cause of action to all legitimately aggrieved investors, preserving state-law class actions where state law presented the only available remedy.

Fourth, state-law class actions are necessary to deter fraud in the securities industry. The limitations of public securities enforcement have repeatedly been recognized by Congress, this Court, and the SEC itself. Petitioner's proposed construction of SLUSA would functionally eliminate any right of action, in any courtroom at any level, for millions of defrauded investors. By denying investors the opportunity to pursue legitimate but low-value claims through class actions, petitioner's preferred interpretation would ensure that the many American households with modest long-term savings will never be compensated adequately for their losses. Such a construction of SLUSA is contrary to the long tradition of private securities enforcement and unnecessary as a practical matter. State legislatures and state courts are more than capable of establishing workable standards to manage non-purchaser and non-seller claims and to prevent frivolous suits.

Accordingly, this Court should affirm the Second Circuit's judgment, which upheld the dismissal of Dabit's amended complaint without prejudice to his ability to plead non-preempted claims on behalf of himself and any others who did not purchase or sell securities in connection with fraud by Merrill Lynch.

ARGUMENT

I. SLUSA DOES NOT PREEMPT SECURITIES FRAUD CLAIMS BROUGHT BY PRIVATE PLAINTIFFS WHO NEITHER BOUGHT NOR SOLD ANY SECURITY IN CONNECTION WITH THE DEFENDANT'S ACTS OR OMISSIONS

A. SLUSA's Text Preserves Holder Claims

1. SLUSA's plain language does not preclude class actions in which the fraud alleged by private plaintiffs is not in connection with their own purchases or sales of securities. When, as here, a statute contains an express pre-emption provision, "the task of statutory construction must in the first instance focus on the plain wording of the clause, which necessarily contains the best evidence of Congress' pre-emptive intent." *CSX Transp., Inc. v. Easterwood*, 507 U.S. 658, 664 (1993); *accord Medtronic, Inc. v. Lohr*, 518 U.S. 470, 484 (1996) ("our analysis of the scope of the pre-emption statute must begin with its text"); *see also Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 517 (1992). For SLUSA to preempt a claim, the private plaintiff must "alleg[e]" misconduct "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1).

The operative language in SLUSA's preemption provision – "in connection with the purchase or sale" – replicates the identical phrase in § 10(b) and Rule 10b-5, both of which proscribe fraudulent conduct "in connection with the purchase or sale of any security." In private securities litigation under § 10(b) and Rule 10b-5, that phrase has a settled judicial interpretation: a private party does not allege misconduct "in connection with the purchase or sale of any security" within the meaning of § 10(b) and Rule 10b-5 unless that misconduct was in connection with the plaintiff's own purchase or sale of a security. *See Blue Chip Stamps*, 421 U.S. at 730-31, 749. "When . . . judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to

incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see Lorillard v. Pons*, 434 U.S. 575, 581 (1978). The phrase "in connection with the purchase or sale" in SLUSA's preemption provision must be given the same construction as the identical language in § 10(b) and Rule 10b-5 in the context in which SLUSA applies – that is, private securities litigation.

2. In *Blue Chip Stamps*, then-Justice Rehnquist's opinion for the Court made clear that the purchaser-seller rule, far from being untethered to the "in connection with the purchase or sale" language of § 10(b), was an interpretation of that language in the context of private suits for damages. For example, the Court stated that "the wording of § 10(b), making fraud *in connection with the purchase or sale of a security* a violation of the Act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large." 421 U.S. at 733 n.5. Referring to *Birnbaum* – the Second Circuit opinion that originated the purchaser-seller rule – the Court observed that longstanding acceptance of "*Birnbaum*'s reasonable interpretation of the wording of § 10(b), wording which is directed toward injury suffered 'in connection with the purchase or sale' of securities, argues significantly in favor of acceptance of the *Birnbaum* rule by this Court." *Id.* at 733 (footnote omitted). The Court added that "[t]he wording of § 10(b) directed at fraud 'in connection with the purchase or sale' of securities stands in contrast with the parallel antifraud provision of the 1933 Act . . . . When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly." *Id.* at 733-34. The Court's reliance on policy concerns in *Blue Chip Stamps* "to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance," *id.* at 737, simply amplifies the rationale for the

purchaser-seller rule as an interpretation of the "in connection with" phrase.[32]

That conclusion draws support from the Second Circuit's reasoning in *Birnbaum*, which undergirded this Court's construction in *Blue Chip Stamps*. In *Birnbaum*, the controlling shareholder and president of a corporation sold his shares at a price that included a substantial control premium, shortly after he had rejected a merger opportunity that would have been highly profitable for all of the company's shareholders. *See* 193 F.2d at 462. Minority shareholders brought suit under Rule 10b-5 against the former controlling shareholder and other former directors, alleging that the defendants had breached their fiduciary duties. *See id.* The district court dismissed the action, explaining that Rule 10b-5 was "aimed only at 'a fraud perpetrated upon the purchaser or seller' of securities and [had] no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers." *Id.* at 463. The Second Circuit agreed, rejecting the plaintiffs' contention that "the applicability of [Rule 10b-5] is not limited to the actual purchasers or sellers of securities," and holding that the "meaning and scope" of Rule 10b-5 must be understood with reference to the SEC's purpose in adopting it. *Id.* Before the adoption of that rule, "[n]o prohibition existed [under federal law] against fraud on a seller of securities by the purchaser if the latter was not a broker or a dealer." *Id.* In adopting Rule 10b-5, the SEC explained that it was closing that "'loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.'" *Id.* (quoting SEC Release No. 3230 (May 21, 1942)). From that, the Second

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[32] *Cf.* Oral Arg. Tr. at 17, *Blue Chip Stamps v. Manor Drug Stores*, No. 74-124 (Mar. 24, 1975) ("*Blue Chip Stamps* Oral Arg. Tr.") ("QUESTION: But it is a construction of the statute that the courts have been engaged in, isn't it? It's not just some judicial policy; it's a construction of the federal statute. MR. RYAN: That's correct.").

Circuit concluded that "the only purpose" of Rule 10b-5 was to make the prohibition against fraud by *sellers* of securities in § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a), applicable to purchasers as well as sellers, and that Rule 10b-5 thus "extended protection *only* to the defrauded purchaser or seller." 193 F.2d at 463-64 (emphasis added).[33]

3. Merrill Lynch and its *amici* contend, however, that the scope of SLUSA's preemption should be governed by this Court's cases involving criminal prosecutions and civil enforcement actions brought by the SEC under § 10(b) and Rule 10b-5. *See, e.g., United States v. O'Hagan*, 521 U.S. 642 (1997). SLUSA's *raison d'être*, however, is the preemption of *private* damages actions brought under state law to evade heightened federal-law pleading rules. Like the *Blue Chip Stamps* rule, SLUSA's preemption provision applies only to civil suits by aggrieved investors. *See* 15 U.S.C. § 78bb(f)(5)(B) (defining a "covered class action" as one seeking damages). There is no reason to think that Congress incorporated or ratified in SLUSA judicial decisions defining the scope of criminal enforcement under § 10(b) and Rule 10b-5; SLUSA has no bearing on, and was not designed to preempt, suits by the government.

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[33] An interpretation of SLUSA's preemption provision that incorporates *Blue Chip Stamps* finds additional support in Congress's decision to tie SLUSA's preemptive scope to the *allegations* in the plaintiff's complaint. SLUSA precludes "covered class action[s]" "by any private party *alleging*" "a misrepresentation or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance" "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1) (emphasis added). In a securities fraud case, a private party alleging misconduct "in connection with the purchase or sale" of securities must aver that the fraud was "in connection with" her own purchase or sale. That statement of fact is what *Blue Chip Stamps* required to allege fraud "in connection with the purchase or sale of any security." Thus, if the plaintiff is a non-transacting holder of securities, she is not in fact a "private party alleging" a misrepresentation or manipulation "in connection with the purchase or sale of a covered security," *id.* Congress's use of language that makes preemption turn on the allegations of a private party confirms that the phrase "in connection with the purchase or sale" in SLUSA must be given the meaning this Court gave those words in *Blue Chip Stamps*.

Indeed, in *O'Hagan*, this Court expressly rejected the notion that civil cases construing § 10(b) defined the scope of criminal § 10(b) liability. *See* 521 U.S. at 664-65 (discussing *Central Bank* and *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258 (1992), and noting that those cases "concerned only private civil litigation under § 10(b) and Rule 10b-5, not criminal liability").

In any event, *O'Hagan* did not hold that the purchaser-seller rule of *Blue Chip Stamps* was unrelated to the texts of § 10(b) and Rule 10b-5. Rather, that case held that the government could prosecute under § 10(b) and Rule 10b-5 a fiduciary who in fact traded on misappropriated financial information. *See* 521 U.S. at 656. In characterizing *Blue Chip Stamps*' holding "that only actual purchasers or sellers of securities may maintain a private civil action under § 10(b) and Rule 10b-5" as motivated by "policy considerations," *O'Hagan* merely emphasized that this limitation was specific to the implied private right of action under § 10(b) and did not determine the scope of § 10(b) liability in regulatory or criminal enforcement suits. *Id.* at 664.

The *O'Hagan* Court's remarks about *Blue Chip Stamps* did not repudiate the latter's conclusion that such a limitation on private suits stems from the phrase "in connection with the purchase or sale" in § 10(b) and Rule 10b-5. *See Blue Chip Stamps*, 421 U.S. at 733 (emphasizing that, in the context of private suits, Congress's wording "is directed toward injury suffered 'in connection with the purchase or sale' of securities"). Indeed, *O'Hagan* had no occasion to question that conclusion, because it did not even involve a private suit for damages. *See SEC v. Edwards*, 540 U.S. 389, 396 (2004) (noting that this Court is not bound by dictum on the meaning of one of its prior decisions); *Maryland v. Wilson*, 519 U.S. 408, 412-13 (1997) (same); *see also Landgraf v. USI Film Products*, 511 U.S. 244, 265 (1994) (reciting "canon of unquestionable vitality . . . 'that general expressions, in every opinion, are to be taken in connection with the case in which

those expressions are used'") (quoting *Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 399 (1821)).

Merrill Lynch is mistaken in suggesting (at 33) that affirming the Second Circuit's judgment would cast doubt on the proposition that the government in a criminal prosecution need not show that a defendant's misconduct was in connection with a particular victim's securities transaction. This case involves the interpretation of SLUSA, not § 10(b) or Rule 10b-5. This Court's acknowledgement that Congress incorporated the rule of *Blue Chip Stamps* in SLUSA when it preempted damages actions by private parties "alleging" fraud "in connection with the purchase or sale" of securities would not alter the settled meaning of § 10(b) and Rule 10b-5.

4. Contrary to Merrill Lynch's assertion (at 7-8), SLUSA's explicit preservation of several categories of claims from preemption without mentioning holder claims, *see* 15 U.S.C. § 78bb(f)(3)-(4), does not mean that Congress intended to preempt non-transacting plaintiffs' actions. The specific carveouts simply demonstrate that SLUSA's preemption is not complete. *Cf. Sprietsma v. Mercury Marine*, 537 U.S. 51, 63-64 (2002) (reading express preemption clause more narrowly because of exception contained in savings clause). In any event, because SLUSA's preemption provision simply does not cover claims by plaintiffs who neither bought nor sold in connection with the defendant's misconduct, Congress had no reason to exempt those claims from SLUSA's preemptive scope.

B. The Presumption Against Preemption Must Be Applied To SLUSA

1. Not only is the foregoing construction of SLUSA's preemption provision true to the text of the clause, it accords with this Court's strong presumption against preemption. "[B]ecause the States are independent sovereigns in our federal system, we have long presumed that Congress does not cavalierly pre-empt state-law causes of action." *Bates v. Dow AgroSciences LLC*, 125 S. Ct. 1788,

1801 (2005) (internal quotation marks omitted); *see also Medtronic*, 518 U.S. at 485 ("In all pre-emption cases, . . . we 'start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'") (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)) (alteration in original). The presumption against preemption applies to discerning whether Congress intended any preemption at all and to gleaning the scope of an express preemption statute. *See id.* Thus, "[e]ven if [Merrill Lynch] had offered [this Court] a plausible alternative reading of [SLUSA's preemption provision] – indeed, even if its alternative were just as plausible as [Dabit's] reading of that text – [this Court] would nevertheless have a duty to accept the reading that disfavors pre-emption." *Bates*, 125 S. Ct. at 1801.

The presumption against preemption is particularly strong where, as here, the conclusion that claims are preempted would eliminate remedies traditionally available under state law. *See id.* State courts have entertained actions for damages by injured investors both before and after the enactment of the 1933 and 1934 Acts, including in circumstances where relief under § 10(b) and Rule 10b-5 would have been precluded under *Blue Chip Stamps*. Specifically, shareholders have brought claims of fraud and misrepresentation to recover for injuries sustained when they were induced to refrain from selling securities, and claims for breaches of fiduciary duty when those breaches have caused decreases in the value of their investments. *See supra* pp. 4-6. This Court expressly acknowledged that tradition in *Blue Chip Stamps*. *See* 421 U.S. at 739 n.9.[34] Nothing in SLUSA's text or background manifests a clear intent to preempt a non-transacting plaintiff's state-law claims, which cannot be brought un-

[34] Indeed, questions arose about the availability of a state-law remedy to plaintiffs who could not allege a claim under *Birnbaum*'s interpretation of § 10(b) and Rule 10b-5. *See Blue Chip Stamps* Oral Arg. Tr. at 22.

der federal law. As was the case in *Medtronic*, "[i]t is, to say the least, 'difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct,' and it would take language much plainer than the text of [SLUSA] to convince [this Court] that Congress intended that result." 518 U.S. at 487 (opinion of Stevens, J.) (quoting *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251 (1984)) (citation omitted).[35]

2. The federal government contends (at 22) that this Court should ignore its presumption against preemption in this case because the federal government has for some time regulated the securities markets and the securities industry requires uniform federal standards. The government is wrong on both counts. To be sure, the federal government has had a prominent role in the regulation of publicly traded securities since the New Deal era. But, in *Bates* and *Medtronic*, federal regulation had existed since 1910 and 1906, respectively, *see Bates*, 125 S. Ct. at 1794; *Medtronic*, 518 U.S. at 475, and this Court nonetheless applied its presumption against preemption. *See also Sprietsma*, 537 U.S. at 56 (first federal statute regulating boat safety enacted in 1910).

Further, the securities industry is no more – in fact, it is less – in need of uniform national standards than the industries involved in prior cases where this Court held that state common-law claims were not preempted. In *Bates*, for example, this Court's conclusion that state-law claims survived preemption created the possibility that Dow would be induced to alter the labels on its pesticides in response to the (possibly divergent) verdicts of 50 States' juries. *See* 125 S. Ct. at 1799. In *Sprietsma* and *Medtronic*, this Court permitted state-law claims to proceed even though those claims challenged the design and manufacture of the defendants' products. *See Sprietsma*, 537 U.S. at 66-67 (claim that defendant manufactured

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[35] The statutes amended by SLUSA explicitly preserved "any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb(a).

an unreasonably dangerous outboard motor because the product lacked a propeller guard not preempted); *Medtronic*, 518 U.S. at 492-94 (defective design claims not preempted). In those cases, the disuniformity permitted by this Court had the potential to force the defendants to make state-specific changes in how they designed and built their products.

That is not the case here: No investment company or securities issuer will, if the Second Circuit's decision is upheld, be forced to alter its products or services in a state-specific fashion, thereby increasing transaction costs for trading in national securities. Instead, to avoid liability under state law, a potential defendant need only tell the truth to the investing public and, specifically, to the millions of Americans pursuing a long-term holding strategy. That approach – simply avoiding misrepresentations, misleading omissions, and the use of manipulative or deceptive devices – is all that is necessary to deal in nationally traded securities without exposure to liability for fraud on holders. *See Cipollone*, 505 U.S. at 529 (plurality op.) ("State-law prohibitions on false statements of material fact do not create 'diverse, nonuniform, and confusing' standards. Unlike state-law obligations concerning the warning necessary to render a product 'reasonably safe,' state-law proscriptions on intentional fraud rely only on a single, uniform standard: falsity.").

The case cited by the government in urging that the presumption against preemption should not apply, *United States v. Locke*, 529 U.S. 89 (2000), is patently inapposite. *Locke* involved "[t]he authority of Congress to regulate interstate navigation" – "an area where the federal interest has been manifest since the beginning of our Republic and is now well established." *Id.* at 99. In the securities field, by contrast, the States were the exclusive regulators until the 1930s, and there has been concurrent state and federal regulation ever since. Although "[u]niformity is undoubtedly important to the [securities] industry," that "interest is not unyielding," *Sprietsma*, 537 U.S. at 70, particularly when, as here, providing the uniformity

sought by Merrill Lynch conflicts with the States' "legitimate and compelling interest in preserving a business climate free of fraud and deceptive practices," *Small*, 65 P.3d at 1264 (internal quotation marks omitted). Given the strong state interest in protecting citizens against fraud – as well as the absence of "diverse, nonuniform, and confusing" state-law standards for fraud, *see Cipollone*, 505 U.S. at 529 (plurality op.) – there is no warrant for abandoning this Court's longstanding presumption against preemption in this case.

C. SLUSA Was Not Intended To Preempt The State-Law Holder Claims Of Investors Who Cannot Bring Claims Under Federal Law

Respondent's interpretation of SLUSA's preemption provision also best suits Congress's purpose, which "'is the ultimate touchstone' in every pre-emption case." *Medtronic*, 518 U.S. at 485 (quoting *Retail Clerks Int'l Ass'n v. Schermerhorn*, 375 U.S. 96, 103 (1963)). As the Second Circuit recognized below, interpreting the phrase "in connection with the purchase or sale" in SLUSA to have the same meaning as it does in the context of private litigation under § 10(b) and Rule 10b-5 fulfills Congress's intention of preempting private damages suits under state law that could have been brought under the implied private right of action to enforce the federal antifraud provisions, with the attendant restrictions of the PSLRA. *See* Pet. App. 21a ("If the 'in connection with' phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA."). Nothing in the legislative history indicates that Congress intended to stop investors from seeking redress through traditional common-law causes of action when the rule of *Blue Chip Stamps* prevents them from alleging claims under federal law.

1. Congress intended to halt the flight to state court of federal § 10(b) suits

Following the PSLRA's enactment, the number of class-action securities lawsuits filed in state court increased somewhat.[36] Congress determined that the increase was due to plaintiffs with federally cognizable claims leaving federal court and filing those same claims under state law in state court to avoid PSLRA requirements. *See, e.g.*, H.R. Conf. Rep. No. 105-803, at 14-15 (1998) (Joint Explanatory Statement of the Committee of Conference).

Congress believed that this flight of plaintiffs from federal to state court, if left unchecked, might undermine Congress's goals in passing the PSLRA. Thus, according to SLUSA's Senate co-sponsor, the Act was intended to halt the migration of suits from federal to state court. *See* 143 Cong. Rec. S10475 (Oct. 7, 1997) (Sen. Gramm) ("[W]hile we had dealt with the problem [of abusive securities lawsuits] in Federal court, we now [after the passage of the PSLRA] were seeing a migration of these lawsuits to State courts with a real effort and apparently a successful effort to circumvent what we had done."). The statements of SLUSA's supporters and critics further confirm that the Act's objective was to ensure that the PSLRA was not gutted by a new wave of state-law claims.[37]

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[36] *See* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 Stan. L. Rev. 273, 298-315 (1998); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1, 42-45 (1998) (concluding that, beyond an initial spike in 1996, no lasting migration from federal to state court could be seen).

[37] *See, e.g.*, H.R. Conf. Rep. No. 105-803, at 14-15 (Joint Explanatory Statement of the Committee of Conference) ("[S]ince passage of the [PSLRA], plaintiffs' lawyers have sought to circumvent the Act's provisions by exploiting differences between Federal and State laws by filing frivolous and speculative lawsuits in State court, where essentially none of the [PSLRA]'s procedural or substantive protections against abusive suits are available."); 143 Cong. Rec. S10476 (Oct. 7, 1997) (Sen. Dodd) (urging SLUSA's passage because "*[t]his migration of frivolous class actions to State court threatens the effectiveness of the reform act*") (emphasis added); 144 Cong. Rec. H6055 (July 21, 1998) (Rep.

To achieve this goal, Congress required all federally cognizable class-action securities suits to be brought in federal court under federal law. *See supra* p. 7. The legislative record is unambiguous: Congress intended only to preempt those suits migrating from federal to state court, and to leave unaffected traditional state-law securities class-action suits. In the words of Senator Dodd, SLUSA's Senate co-sponsor, "[SLUSA] will [allow Congress to address this state litigation problem] in a very targeted and narrow way, *essentially preempting only those class actions that have recently migrated to State court, while leaving traditional State court actions and procedures solidly in place. . . . This legislation has been carefully crafted only to affect those types of class actions that are appropriately heard on the Federal level.*" 143 Cong. Rec. S10477 (Oct. 7, 1997) (emphasis added). Although petitioner attempts to downplay this explanation of SLUSA's scope as that of a "single Senator," Pet. Br. 17, that very same sentiment was echoed by other sponsors of the legislation. *See, e.g.*, 144 Cong. Rec. E1385 (July 22, 1998) (Rep. Fazio) ("*Only those suits traditionally filed in Federal courts would be affected by H.R. 1689, while those claims that historically have been pursued in State courts would be left undisturbed.*") (emphasis added); *id.* at E1390 (Rep. Eshoo) ("I would like to make clear that *the bill is not a*

Bliley) ("The Uniform Standards Act will permit meritorious claims to continue to be filed *while preventing the migration of baseless class actions to state courts*. . . . This legislation will put a stop to the inappropriate use of state courts to circumvent the protections that Congress deemed appropriate in 1995 [in the PSLRA].") (emphasis added); *id.* at H10780 (Oct. 13, 1998) (Rep. Eshoo) ("These frivolous suits, traditionally filed in Federal courts, are now being filed in State courts circumventing the intent of the Congress in [the PSLRA]."); *id.* at H10786 (Rep. Tauzin) ("We are back here today because in spite of the fact that we put an end to these strike lawsuits [by passing the PSLRA] . . . we learned that the unscrupulous members of the trial board who were pressing these cases before simply did an end around. They went to State court and increasingly used the authority of the State court to do exactly what they used to do in Federal court . . . . *In short, this [statute] is carefully tailored now to stop the end runs* . . . .") (emphasis added).

federal power grab. We are returning to federal courts cases which until the 1995 Reform Act had always been heard in federal courts. [SLUSA] is limited in scope . . . .") (emphasis added).

Amici assert that Congress was unaware of *Blue Chip Stamps* and the purchaser-seller rule at the time of SLUSA's passage. *See* Investment Co. Inst. *Amicus* Br. 10-11 (asserting that "one might reasonably expect at least one reference to *Blue Chip Stamps*, or the purchaser/seller standing limitation, in the debates that preceded SLUSA's enactment. But there is none. It does not appear from the record that *Blue Chip Stamps* was even considered, let alone implicitly codified, by any legislator who voted on SLUSA."). This plainly erroneous assertion ignores the legislative record. Congress was well aware of *Blue Chip Stamps* and the purchaser-seller limitation. Indeed, both were discussed as part of the penultimate debate on SLUSA's passage. *See* 144 Cong. Rec. H10775 (Oct. 13, 1998) (Dissenting Views of Joint Explanatory Statement of the Committee of Conference) (lamenting the retainer of recklessness liability and arguing that, "just as *there is no remedy under Section 10(b) for those who neither purchase nor sell securities because Congress knew how to create such a remedy but did not*, there can be no liability for reckless conduct under Section 10(b) because Congress clearly knew how to impose liability for reckless behavior but did not") (emphasis added) (citing *Blue Chip Stamps*, 421 U.S. at 734).

Congress understood that, by selecting the "in connection with" language interpreted in *Blue Chip Stamps*, it had preserved claims by holders. *See Blue Chip Stamps*, 421 U.S. at 733-34 ("When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly."). Congress could have selected different language that would completely preempt all securities litigation, *including* holder claims, had that been SLUSA's goal. For example, Congress might have preempted all state-law class actions alleging harm in connection with the purchase, sale, or *re-*

tention of a security. Using broader language still, Congress might have preempted all actions involving or relating to a nationally traded security. But Congress did not select such language. Instead, it chose the very text interpreted by this Court in *Blue Chip Stamps*, text that – in this Court's view – evidenced a congressional intent not to encompass non-purchasers and non-sellers.

Thus, in specifying rules for "purchase" and "sale" alone, Congress consciously chose not to address holder claims. This was true when Congress declined to authorize holder claims in enacting § 10(b), and it was true again when Congress declined to preempt holder claims in enacting SLUSA. Congress's awareness of *Blue Chip Stamps*, and its understanding of the textual basis for that decision, further bolsters the traditional presumption that Congress intended to ratify that judicial construction when it enacted SLUSA. *See supra* pp. 21-23.

2. Congress intended to preserve a private right of action for all victims of fraud

Congress recognized the necessity of offering, at either the state or federal level, a private right of action for all legitimately aggrieved parties. In enacting SLUSA, it endeavored to prevent abusive litigation while still securing a private right of action to all genuine victims of fraud. SLUSA's Senate co-sponsor recognized "just how important the private litigation system has been in maintaining the integrity of our capital markets," as "[i]t is highly questionable whether our markets would be as deep, as liquid, as strong, as transparent, were it not for our system of maintaining private rights of action against those who commit fraud." 143 Cong. Rec. S10476 (Oct. 7, 1997) (Sen. Dodd). This same concern with preserving a right of action for all aggrieved investors animated many stages of the Act's progress through Congress.[38] Neither the proce-

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[38] *See, e.g.*, 144 Cong. Rec. H10777 (Oct. 13, 1998) (Letter from Sen. Reed to Sen. Dingell) ("Only a meaningful right of action against those who defraud can guarantee investor confidence in our national markets."); *id.* at E1424 (July 24, 1998) (Rep. Harman) ("Mr. Speaker, let

dural requirements established in the PSLRA, nor the limitation on federal flight established in SLUSA, conflict with that clear purpose. Holder claims are an important element of traditional state-law securities regulation and have been recognized by several States for more than a century. *See supra* pp. 4-6. The PSLRA and SLUSA preserved that component of the current regulatory scheme, without which many instances of securities fraud would go unremedied.

3. Congress did not intend to eliminate all state securities class actions

Petitioner claims that Congress enacted SLUSA to create a single, uniform system of securities litigation. *See* Pet. Br. 34; *see also* U.S. Br. 24. That contention, however, ignores the limitations of the statutory scheme. In crafting SLUSA's language, Congress permitted state law to apply to nationally traded securities through private actions of 49 or fewer investors, *see supra* p. 7, and through public enforcement of state statutes by appropriate state entities, *see id.* Thus, consistent with congres-

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me assure my colleagues that the reform measure before us continues to protect investors. *It recognizes the important role the private litigation system has played in maintaining the integrity of our capital markets.* Yet, at the same time, the bill recognizes that forum shopping cannot be a new pathway for enterprising parties to gain new profits. *The rights of the aggrieved investor to seek justice and restitution is maintained,* while the opportunity to manipulate procedures to the detriment of the company and legitimate investors is hopefully ended.") (emphases added); *id.* at S12445 (Oct. 13, 1998) (Rep. D'Amato) ("Now, let me make one thing clear – *we are not talking about preventing legitimate litigation. Real plaintiffs with legitimate claims deserve their day in court.* . . . Companies that engage in fraudulent conduct should be held fully liable for their actions . . . .") (emphasis added); *id.* at H10779 (Rep. Oxley) ("The conference report preserves the ability of individual investors to file suits that are appropriately brought in State courts, while preventing lawyers from using securities class actions filed in State court for their personal gains."); *see also id.* at S12906 (Oct. 21, 1998) (Sen. Reed) ("[A]s the Senate considered partially preempting state law [in the PSLRA], many Senators, including the primary sponsors of the bill, made clear that preemption would only occur if the federal standard insured investors protection from fraud.").

sional intent, securities litigation is not uniformly federal after SLUSA. Class-action suits by 50 or more purchasers and sellers with federal claims must uniformly be brought under federal law and in federal court; but a company whose securities are nationally traded must still comply with up to 51 different sets of regulations, as state law applies through public enforcement actions or through suits brought by small groups of investors with potentially significant holdings in the company. Such a company must, after SLUSA's passage, comply with different state standards regarding registration of securities,[39] scienter,[40] aiding and abetting,[41] and causation.[42] It is therefore inaccurate to claim that, were holder claims permitted, "uniformity" would be lost in securities regulation.

Moreover, petitioner's assertion that SLUSA's goal was absolute "uniformity" in the class-action field cannot be reconciled with the text of the Act or the legislative record. In SLUSA, Congress explicitly found that "[s]tate securities regulation is of continuing importance, together with Federal regulation of securities, to protect investors and

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[39] *See, e.g., A.S. Goldmen & Co. v. New Jersey Bureau of Sec.*, 163 F.3d 780, 782 (3d Cir. 1999) (noting that New Jersey's securities laws require registration of some securities immune from registration under federal law, and upholding the ability of New Jersey securities regulators to prohibit the national offering of unregistered securities by a New Jersey company, even though the relevant securities were not required to be registered federally).

[40] *See, e.g., Secretary of State v. Tretiak*, 22 P.3d 1134, 1140 (Nev. 2001) (holding that "reliance and scienter are not required elements of securities fraud in state enforcement actions"); *Kittilson v. Ford*, 608 P.2d 264, 265 (Wash. 1980) (holding that negligence is sufficient to impose liability under state securities law); *Merrill Lynch, Pierce, Fenner & Smith v. Byrne*, 320 So. 2d 436, 440 (Fla. Dist. Ct. App. 1975) (same).

[41] *See, e.g., Riedel v. Acutote of Colorado*, 773 F. Supp. 1055, 1066 (S.D. Ohio 1991) (noting that state securities law imposed liability on one who "participated in or aided the seller in any way" in a sale, making secondary liability under state law "much broader than the parallel federal provision").

[42] *See, e.g., E.F. Hutton & Co. v. Rousseff*, 537 So. 2d 978, 981 (Fla. 1989) (holding that proof of loss causation is not required for liability under state securities law).

promote strong financial markets." § 2(4), 112 Stat. 3227. SLUSA's sponsors and supporters were careful to note that the bill did not preempt all state-law securities class-action lawsuits. *See, e.g.*, H.R. Conf. Rep. No. 105-803, at 15 (Joint Explanatory Statement of the Committee of Conference) ("The solution to this problem [of 'federal flight'] is to make Federal court the exclusive venue for *most* securities fraud class action litigation involving nationally traded securities.") (emphasis added); 143 Cong. Rec. S10477 (Oct. 7, 1997) (Sen. Dodd) (stating that SLUSA will preempt "only those class actions that have recently migrated to State court," but not displacing others "traditional[ly]" heard in state court); *id.* ("[t]his legislation has been carefully crafted only to affect *those types* of class actions that are appropriately heard on the Federal level," recognizing that other "types" of securities class actions are appropriately heard in state court) (emphasis added); 144 Cong. Rec. S4802 (May 13, 1998) (Sen. Kerry) (noting that SLUSA covers "class action lawsuits alleging the commission of securities fraud in connection with the purchase or sale of a covered security," and concluding that "all class action suits of *this type*" should be "brought in federal courts") (emphasis added). Contrary to petitioner's assertion, those statements illustrate that Congress intended *some* number of state-law securities class actions to survive after SLUSA's enactment.

Merrill Lynch and its *amici* place great emphasis on a statement by the Seventh Circuit that "[i]t would be more than a little strange if the Supreme Court's decision [in *Blue Chip Stamps*] to block private litigation by nontraders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all." *Kircher*, 403 F.3d at 484. But there is nothing strange about a conclusion that holder claims fall outside SLUSA's scope, because the Seventh Circuit is simply wrong that Congress mandated in SLUSA that "securities class actions must proceed under federal securities law or not at

all." *Id.* Congress did not intend to preempt *all* state-law class actions involving securities. Indeed, if it had, it could have achieved that result in much plainer language. More fundamentally, there is nothing anomalous or illogical in recognizing that Congress, in precluding damages suits under state law that could have been brought under federal law, intended to restrict the operation of SLUSA's preemption provision to actions by those who traded in connection with the alleged fraud – that is, actions that could have been brought under federal law. An anomaly would be created, however, if this Court were to agree with the Seventh Circuit that *Blue Chip Stamps* justifies an interpretation of SLUSA that would deny to investors the very types of claims that *Blue Chip Stamps* said are available only under state law to plaintiffs because such claims do not exist under § 10(b) and Rule 10b-5.

D. The Second Circuit's Reading Of SLUSA's Preemption Provision Advances The Policies Underlying The Federal Securities Laws

Federal securities laws, which SLUSA merely amended, "'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.'" *Central Bank*, 511 U.S. at 171 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)) (alteration in original). Continuing to permit private plaintiffs to bring holder claims under state law, as they have done for more than a century, furthers that "fundamental purpose." On the other hand, abolishing holder claims shields wrongdoers from liability and threatens the integrity of America's financial markets. Indeed, the Seventh Circuit candidly admitted that its reading of SLUSA's preemption provision would leave some injuries in the hands of public prosecutors, which have been slow to respond to innovative forms of securities fraud, such as market timing. *See Kircher*, 403 F.3d at 484.

1. Meaningful private enforcement is necessary to preserve the integrity of this country's financial markets

At the time of SLUSA's consideration, the then-Chairman of the SEC reminded Congress that a private right of action was an invaluable element in securities regulation efforts:

> *The Commission has always relied, and continues to rely, on private actions in both federal and state courts to support the agency's efforts to combat fraud.* Private actions are an especially important supplement to the Commission's enforcement program today because of the phenomenal growth of the securities industry during a time when the Commission's staff and budget levels have remained relatively constant. *The importance of private actions has been reinforced by the recently reported rise in fraud similar to that witnessed during the bull market of the 1980s.*

Prepared Testimony of The Honorable Arthur Levitt, Jr., SEC Chairman, and The Honorable Isaac C. Hunt, SEC Commissioner, Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs (Oct. 29, 1997) (emphases added). These sentiments echoed the longstanding position of the Commission.[43]

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[43] *See Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 15-16 (1991) (testimony of Richard C. Breeden, SEC Chairman) (explaining that a meaningful private right of action is necessary to supplement the SEC's enforcement activity, because the SEC is able to prosecute only a fraction of the cases in which investors have suffered losses); *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 113-14 (1993) (testimony of William R. McLucas, Director, SEC Division of Enforcement) (explaining that the SEC is unable to address all securities violations and that SEC enforcement actions cannot substitute for private actions in allowing investors to recover losses, because, "[a]lthough the Commission usually makes disgorged funds available for the compensation of injured investors, the amount of investor losses often exceeds the wrongdoer's ill-gotten gains") (footnote omitted). The

Congress took the SEC's warnings to heart, and itself noted that a private right of action is invaluable to the maintenance of healthy markets. *See supra* pp. 36-37. Indeed, Congress has recently reaffirmed its commitment to providing a meaningful private right of action for aggrieved investors. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 306(a)(2)(B), 116 Stat. 745, 779, codified at 15 U.S.C. § 7244(a)(2)(B) (creating a new private right of action against directors or officers buying or selling certain securities during specified periods); *id.* § 804(a)(2), 116 Stat. 801, codified at 28 U.S.C. § 1658(b) (extending the statute of limitations on securities fraud claims). This Court has often noted that a private right of action is indispensable in encouraging efficient national markets and maintaining investment levels.[44]

Petitioner's proposed construction of the Act ignores that reality and functionally eliminates any right of action for millions of victims of market manipulation. The abolition of holder claims would seriously distort financial markets by precluding compensation for massive and longstanding fraud. As a result of market timing alone, millions of investors have suffered what a leading mutual fund manager describes as $5 to $10 billion per year in dilution and depletion of their securities holdings.[45] *See*

SEC has presented similar views to this Court in prior litigation. *See, e.g.*, Brief for the SEC as *Amicus Curiae* in Support of Partial Affirmance at 6, *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983) (Nos. 81-680 & 81-1076), 1982 WL 608452 ("Given the limited enforcement resources of the Commission, the private right of action is vital to effective enforcement of Section 10(b).").

[44] *See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) ("[W]e repeatedly have emphasized that implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to [SEC] action.'") (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

[45] Market timers have operated unchecked for a great many years. *See, e.g.*, Don M. Chance & Michael L. Hemler, *The Performance of Professional Market Timers: Daily Evidence from Executed Strategies*, 62 J. Fin. Econ. 377, 378 (2001) (tracking "the performance of 30 professional market timers during 1986-1994").

supra pp. 11-14. Yet, as of May 2005, the SEC had brought only 29 enforcement actions against mutual funds and their employees, and had recovered less than $2 billion in settlements.[46] That recovery, while not insubstantial, represents only a fraction of the tens of billions in losses caused by market timers prior to 2003. Moreover, no more than $1 billion of the recovery has been earmarked for restitution to aggrieved investors.[47] Because only holders (and not purchasers or sellers) are the victims of market timing, *see supra* pp. 12-13, a private right of action for holders is the only remedy for the millions of investors whose long-term savings have been diluted. As the SEC itself recognizes, *see supra* note 43, public enforcement is simply insufficient to that task.

2. Class actions are necessary for effective enforcement of securities regulations

Just as it ignores the realities of securities enforcement, petitioner's proposed construction of SLUSA ignores the realities of modern litigation and the fact that meritorious and socially desirable claims will not be brought if the costs of litigation are prohibitively high. It is not true that injured investors whose claims would be preempted under petitioner's theory will simply file suit individually rather than as part of a class action. Between 1996 and 2001, the average fund-holding American family lost approximately $3,740 of its long-term savings to several forms of market manipulation. *See supra* p. 11 & note 20. Although that average dollar amount is a significant sum, it is likely not enough to make an individual suit for damages economically viable. Millions of families, moreover, suffered losses of less than that average figure, but that involve billions of dollars in the aggregate. For many ordinary stockholders, the denial of class relief would mean no relief at all. As this Court has recognized, "'[t]he policy

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[46] *See* 2005 House Hearing at 22 (Fig. 1) (Hillman Statement), 38 (Richards Statement).

[47] *See id.* at 21 (Hillman Statement) (estimating restitution at $800 million to $1 billion).

at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.'" *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 617 (1997) (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)); *accord Deposit Guar. Nat'l Bank v. Roper*, 445 U.S. 326, 338 n.9 (1980). The unavailability of class-action lawsuits in this context would be a tremendous windfall for the many perpetrators of fraud whose conduct escapes the enforcement of federal or state authorities. It would also ensure that millions of Americans go uncompensated for their losses – losses that may exceed the windfall received by defrauding parties.

3. Holder claims are not unmanageable or inherently abusive

By affirming the decision below, this Court would not invite abusive complaints. The Second Circuit was careful to establish safeguards against frivolous lawsuits by sham holders. To plead a valid holder claim for fraud in the Second Circuit, a plaintiff must demonstrate that her purchase of the security occurred *before* the onset of the misrepresentation or omission of the defendant. *See* Pet. App. 38a-39a. If the complaint is silent as to the manner in which class members came to own the relevant securities, or if it includes a mix of purchasers (some in reliance on the fraud, others not in reliance), the complaint cannot proceed; the decision below requires that the plaintiff's class definition explicitly disclaim those who purchased in reliance on the fraud. *See id.* at 41a-43a. Under the Second Circuit's standard, only individuals who purchased pre-fraud and therefore could not bring purchaser claims, and who did not sell in reliance on the fraud and therefore could not bring seller claims, will qualify as class members. *See, e.g., Gordon v. Buntrock*, No. 00 CV 303, 2000 U.S. Dist. LEXIS 5977, at *10-*11 (N.D. Ill. Apr. 28, 2000) (noting that plaintiff had gone to great lengths to stress that his complaint alleged misrepresentations only in connection with the holding of securities, and that class

members had not been deceived into initially purchasing the stock). It is simply not true that "virtually any purchaser or seller claim could, if gerrymandered as to the timing of the class period and tweaked a bit in its allegations, be stated as a holder suit." Chamber of Commerce *Amicus* Br. 25; *accord* U.S. Br. 28-29. In fact, the opposite is true: an individual with a viable purchaser claim will not have a viable holder claim, and vice versa.

Although the Second Circuit has already taken steps to safeguard against holder claims that are speculative or that merely attempt to circumvent the pleading requirements for purchaser-seller claims, state courts are of course fully equipped to ensure that only plaintiffs with meritorious claims proceed to trial and recover. State courts have established their own, often stringent, pleading requirements for state-law holder claims. Some courts have held that holders of securities could not plead actionable claims for relief under state common law because their claims either were "too speculative"[48] or should have been brought as derivative actions[49]; because the investors could not establish either loss causation[50] or reliance[51]; or because the State declined to recognize a securities fraud claim for those who are neither purchasers nor sellers.[52]

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[48] *See Crocker v. FDIC*, 826 F.2d 347, 350-51 (5th Cir. 1987) (applying Mississippi law); *Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011, 1018 (D. Conn.) (applying Connecticut law), *aff'd*, 31 F.3d 66 (2d Cir. 1994).

[49] *See, e.g., Smith v. Waste Mgmt., Inc.*, 407 F.3d 381 (5th Cir. 2005) (Delaware law); *Arent v. Distribution Sciences, Inc.*, 975 F.2d 1370, 1372-73 (8th Cir. 1992) (Minnesota law); *Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690, 692 (7th Cir. 1990) (Illinois law).

[50] *See, e.g., Arent*, 975 F.2d at 1374; *Kagan*, 907 F.2d at 692; *Crocker*, 826 F.2d at 351-52.

[51] *See In re WorldCom, Inc. Sec. Litig.*, 382 F. Supp. 2d 549, 559-60 (S.D.N.Y. 2005) (applying New York Law); *Rogers*, 268 F. Supp. 2d at 1313-14.

[52] *See Loop Corp. v. McIlroy*, No. A04-362, 2004 WL 2221619, at *5 (Minn. Ct. App. Oct. 5, 2004) ("Minnesota law has not recognized a common-law holding claim related to securities."); *see also In re WorldCom, Inc. Sec. Litig.*, 336 F. Supp. 2d 310, 322-23 (S.D.N.Y. 2004) (pre-

As is typically the case in our federal system, each State remains free to craft its own procedural rules and evidentiary standards for managing holder claims. States can, for example, build in a corroboration requirement, such that mere subjective belief will not state a claim. *See Small*, 65 P.3d at 1265 (requiring holders to allege "actions, as distinguished from unspoken and unrecorded thoughts and decisions, that would indicate that the plaintiff actually relied on the misrepresentations" in deciding not to sell a security). As for the concern that issuers could be "hauled into court 'any time a stock price fluctuated,'" that "could only happen after the plaintiff(s) had decided to shoulder 'the formidable task of proving common law fraud.'" *Greenfield v. Fritz Cos.*, 98 Cal. Rptr. 2d 530, 543 (Cal. Ct. App. 2000), *rev'd on other grounds sub nom. Small v. Fritz Cos.*, 65 P.3d 1255 (Cal. 2003). Indeed, the California Supreme Court requires holders to "allege specific reliance on the defendants' representations: for example, that if the plaintiff had read a truthful account of the corporation's financial status the plaintiff would have sold the stock, how many shares the plaintiff would have sold, and when the sale would have taken place." *Small*, 65 P.3d at 1265. And most States reject the fraud-on-the-market theory of proving reliance that prevails in federal court under *Basic Inc. v. Levinson*, 485 U.S. 224, 241-49 (1988). *See, e.g., Mirkin v. Wasserman*, 858 P.2d 568, 584 (Cal. 1993) (refusing to incorporate the fraud-on-the-market doctrine into the law of deceit). In addition to requiring plaintiffs to plead and prove the elements of whatever claim they seek to bring, States are free to reject holder claims altogether. *See supra* note 52 (collecting cases rejecting holder claims under state law). States should be afforded the opportunity to create a

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dicting that Georgia Supreme Court would not permit plaintiffs' putative class action to proceed because it would not "recognize a cause of action for a class of plaintiffs who are alleged to have held their stock in reliance on misrepresentations or omissions," or, if it did, it would require allegations of individualized, justifiable reliance).

workable balance between the rights of aggrieved investors and the needs of defendants and the judicial system.

In addition, the potential for abuse through true "holder" claims – that is, claims by persons induced to hold their securities or harmed while holding securities – is not nearly as great as that for mere non-purchaser claims of the sort at issue in *Blue Chip Stamps*. With respect to the latter claims, a near-infinite universe of potential plaintiffs could assert that they subjectively intended to purchase a stock, but were induced not to do so by the defendant's fraud. With respect to the former, only those persons having already purchased the security prior to the advent of the fraud would be permitted to bring suit. Any difficulties of proof in such suits are not insurmountable and do not justify denying holder plaintiffs access to both state and federal court.[53] Indeed, non-seller suits, by definition, provide evidence to cabin the speculative nature of the suit. Whereas a non-purchaser could assert an intent to purchase any number of shares, exposing the defendant to nearly unlimited damages, a non-seller claim is necessarily limited to the number of shares that the seller held at the time of the induced non-sale. Accordingly, the non-seller claims that would be permitted to proceed under a proper construction of the Act are not subject to the same type of abuse as the non-purchaser claims considered by this Court in *Blue Chip Stamps*, which were "unconstrained by any such anchor in demonstrable fact." *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1092 (1991).

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[53] In at least some cases, plaintiffs will be able to provide convincing evidence corroborating their desire to sell and the inducement leading them to forbear that sale. *See, e.g., supra* note 13 (discussing Merrill Lynch settlement with Debasis Kanjilal, who called his Merrill Lynch investment advisors daily and communicated his desire to sell certain stocks, but was repeatedly encouraged to "sit tight"). Moreover, given that the plaintiff in a non-seller case has already purchased at least one security (the security at issue in the complaint), it is conceivable that the plaintiff could prove an intent to sell by providing evidence of prior patterns of purchase and sale activity.

Merrill Lynch and its *amici* further contend that classes of holders who have been fraudulently induced by public statements to retain stock in publicly traded companies cannot establish that they have been harmed. They claim that the damages of those holders would be either (1) nothing, as the earlier revelation of the truth would have caused the same loss in value to the stock, or (2) too speculative to maintain. Their contention is incorrect in both respects, and more fundamentally, is irrelevant to the question before this Court.

First, it is far from clear that a security loses the same value when, on the one hand, negative information is released in a timely and permissible manner, and, on the other, the same information is fraudulently withheld for some period of time and is then either discovered or revealed. It defies common sense to suppose that the entire decrease in value following a belated disclosure – such as a significant accounting restatement – is attributable to the mere learning of bad news. Much of that drop in stock price is likely a result of the impact of the discovery of fraud on investor confidence in the issuer's management. The fraud might also expose the company to monetary liability in civil and criminal proceedings, and the market is likely to look skeptically upon other non-fraudulent disclosures by the corporation, causing a further decrease in the stock's value. *See Small*, 65 P.3d at 1271 (Baxter, J., concurring) (observing that "delayed disclosure of bad news, under circumstances suggesting that earlier reports were dishonestly or incompetently false, might have an effect on the market price of the shares beyond the effect of the bad news itself").

Second, the damages in a holder suit are no more speculative than for many traditional causes of action. As with other torts alleging the temporary or permanent destruction in value of private property (such as misappropriation or conversion), damages may be ascertained by submitting expert testimony on the quantum of temporarily reduced value in the property – for example, the opportunity cost to the plaintiff of the defendant's wrongdoing. Any diffi-

culties in obtaining this proof do not justify denying a plaintiff the opportunity to submit such evidence to a jury. *See id.* at 1270 (Kennard, J., concurring) ("Experts may disagree – they often do – but that is no reason to reject a holder's cause of action."). Moreover, there is no need to peg a holder's damages to an actual sale or to discount a holder's damages based on a post-fraud increase in the value of the security. Even a subsequent increase in the price of the stock does not fully compensate an aggrieved holder. The asset, for the period that its value was diminished, caused its owner a tangible loss, as it was not available for any number of uses (such as collateral for a loan). *See id.* at 1267 (Kennard, J., concurring) (collecting examples of tangible harms inflicted absent a sale of the security). That is enough – as it is in an action for misappropriation or conversion – to state a claim for the loss caused by the temporary deprivation of the property's full value. Even if the loss suffered by an investor in a publicly traded company who is fraudulently induced to hold shares is not cognizable under federal law, our federal system permits States to define the contours of their common-law claims. *See, e.g., id.* at 1263-64.

In any event, the contentions of Merrill Lynch and its *amici* are irrelevant to the present inquiry. The operative question at this stage is not "whether [state] law would permit recovery on such a theory, but only whether the putative state-law claim falls within SLUSA's preemptive scope." Pet. App. 38a n.14. *See also id.* at 44a n.16 ("[I]n considering whether a claim is preempted by SLUSA we do not consider the merit of the claim under state law.").

II. THE SECOND CIRCUIT'S DISPOSITION OF THIS CASE SHOULD BE AFFIRMED

The Court should affirm the Second Circuit's judgment upholding the dismissal of Dabit's amended complaint without prejudice to his ability to file a new complaint containing claims that would not be preempted under the Second Circuit's interpretation of SLUSA. Dabit may plead several successful holder claims consistent with the

Second Circuit's requirements. Although we detail multiple theories of relief that SLUSA would not preempt, we also note that, "[b]ecause the pre-emption defense raises a threshold issue, [this Court has] no occasion to consider the merits of [Dabit's] claims, or even whether the claims are viable as a matter of [state] law." *Sprietsma*, 537 U.S. at 56; *see also Medtronic*, 518 U.S. at 495 (noting that "the precise contours of [the plaintiffs'] theory of recovery have not yet been defined").

Fraudulent inducement to hold. Dabit purchased securities prior to the provision of any biased investment reports by Merrill Lynch analysts, and subsequently held those securities on the basis of Merrill Lynch's recommendations. He therefore may seek to recover for the damages he suffered as a consequence of his induced failure to sell. That is the allegation Dabit attempted to make in his first amended class-action complaint. *See* JA 52a (¶ 1) (describing the class as one consisting of brokers who "owned and continued to own" securities recommended by Merrill Lynch during the class period); *id.* (¶ 2) (alleging that, "*after* Plaintiff[']s purchase of the [securities]," Merrill Lynch "failed to advise Plaintiff of the fact of the decreasing values of the [securities], and misrepresented to Plaintiff that the [securities] were worthy of holding in Plaintiff's or Plaintiff's clients' portfolio") (emphasis added).

Market-timing injuries. Dabit also owned mutual funds offered by Merrill Lynch for his and his clients' accounts, *see supra* note 16, and therefore may attempt to recover for the actions of the fund managers in permitting market timers to dilute fund assets.[54] As noted above, *see supra* pp. 13-14, many mutual funds published, but did not adhere to, policies designed to discourage or eliminate market timing. Dabit may be able to plead a holder claim for the fund's intentional non-compliance with those pro-

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[54] If such funds were managed by a different Merrill Lynch entity, Dabit presumably would be free on remand to add that entity as a defendant. *See* Fed. R. Civ. P. 19, 20.

cedures. For funds with a large proportion of international assets traded on foreign exchanges, such a claim might be significant, as those funds were particularly susceptible to time-zone arbitrage. *See id.* at 12.

Of course, Dabit may have other claims, unrelated to any fraud in connection with the purchase or sale of securities, that can proceed without regard to whether SLUSA preempts holder claims and that Dabit should have the opportunity to plead. This Court granted certiorari to resolve a conflict in the courts of appeals on the meaning of the phrase "in connection with the purchase or sale of a covered security" in SLUSA. *See* Pet. i. Even if this Court reverses the Second Circuit, not every class action of 50 persons or more proceeding under state law that alleges misconduct "coincid[ing]," *Zandford*, 535 U.S. at 820, with a transaction in a nationally traded security will be preempted by SLUSA. For SLUSA to apply, the plaintiff must allege "a misrepresentation or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance," 15 U.S.C. § 78bb(f)(1). Plaintiffs such as Dabit may still bring class actions under state law to recover for harm caused by, for example, negligence; breach of contract, *see Falkowski v. Imation Corp.*, 309 F.3d 1123, 1131 (2002), *amended on other grounds*, 320 F.3d 905 (9th Cir. 2003); *Norman v. Salomon Smith Barney Inc.*, 350 F. Supp. 2d 382, 385-88 (S.D.N.Y. 2004); *Xpedior Creditor Trust v. Credit Suisse First Boston (USA) Inc.*, 341 F. Supp. 2d 258, 269-70 (S.D.N.Y. 2004); or breach of fiduciary duties or the implied covenants of good faith and fair dealing, *see Norman*, 350 F. Supp. 2d at 385-88; *Xpedior Creditor Trust*, 341 F. Supp. 2d at 269-70; *cf. Kircher*, 403 F.3d at 482-83 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977)). That does not mean, of course, that a plaintiff can avoid SLUSA preemption merely by omitting to plead that a misrepresentation was made with scienter, as required by *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, 199 (1976). But when a claim does not require the plaintiff to prove that the defendant made a misrepresentation or omission, or

engaged in manipulation, the existence of such facts does not bring the claims within SLUSA's preemptive scope.[55]

Lost fees. Dabit also has asserted a separate claim for fees lost when customers transferred their brokerage accounts from Merrill Lynch following disclosures of its biased and misleading investment advice. *See* JA 52a. The Second Circuit recognized that that claim did "not allege fraud that 'coincide[s]' with the sale or purchase of a security," Pet. App. 44a (quoting *Zandford*, 535 U.S. at 825), and held it not preempted, *id.* Merrill Lynch did not seek this Court's review of that aspect of the court of appeals' judgment. On remand, an additional theory of non-preempted lost fees could be based on an allegation that Merrill Lynch's fraud reduced the asset values in the portfolios of Dabit's clients, causing a corresponding reduction in fees collected based on a percentage of assets under management.

CONCLUSION

The judgment of the court of appeals should be affirmed.

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[55] *Cf. Bates*, 125 S. Ct. at 1798 (noting that preemption was inappropriate unless a state rule both (1) established a requirement "for labeling or packaging," and (2) imposed a requirement "in addition to or different from" federal law; holding that, where common-law rules established rules for product *design* or *testing*, rather than rules for *labeling* or *packaging*, suits on those common-law theories were not preempted). Without regard to this Court's construction of the "in connection with the purchase or sale" standard, common-law claims not requiring a plaintiff to allege a "misrepresentation or omission" are not preempted by SLUSA. *See id.* at 1797-99 (concluding that, because "[t]he proper inquiry calls for an examination of the elements of the common-law duty at issue," defective product design claims did not establish a requirement for "labeling" and "packaging," and therefore were not preempted).

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No. 04-1371

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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STATEMENT PURSUANT TO RULE 29.6

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari and there are no amendments to that statement.

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Lewis D. Lowenfels & Alan R. Bromberg, *Beyond Precedent: Arbitral Extensions of Securities Law*, 57 Bus. Law. 999 (2002) 18

The Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227, expressly preempts certain state law class actions based on the substance of the allegations in the complaint: "*No* covered class action" under state law may be maintained "by *any* private party alleging" deception or misrepresentation "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1) (emphasis added). Disregarding the statutory text, the court of appeals concluded that SLUSA preemption does not extend to state law class actions by "any private party" alleging the specified misconduct, but rather only precludes actions based on the identity of the private class action plaintiffs as purchasers or sellers of securities. That holding, and the arguments of Respondent and *amici* in support thereof, ignore the plain language and natural meaning of the express preemption provision; misconstrue the *Blue Chip Stamps* policy-based standing requirement as a construction of the "in connection with the purchase or sale" statutory language; seek to avoid the dispositive effect of prior decisions of the Court by adopting a novel and unsupported claim that the same statutory language has a different and more restrictive meaning in the private civil than in the criminal context; and misapprehend the purpose of SLUSA.

I. SLUSA Preemption Is Triggered By The Nature Of The Misconduct Alleged, Not By The Identity Of Plaintiffs

Had Congress intended by SLUSA to limit preempted class actions to those brought by purchasers or sellers of securities, it could easily have stated that

> "No covered class action based upon the statutory or common law of any State . . . may be maintained in any State or Federal court by any private party *who purchased or sold a covered security* alleging an untrue statement or omission of a material fact or the use or employ of any manipulative or deceptive device or contrivance by defendant."

See, e.g., Pet. Br. at 23 (listing provisions in the securities laws where Congress expressly limited statutory coverage only to purchasers or sellers of securities). Instead, Congress used a more inclusive formulation that turns on the substance of the

allegations against defendant rather than the identity of the class action plaintiffs as triggering preemption: Congress preempted all covered class actions by "any private party" alleging certain acts, which were set off in two separate subparagraphs, and each of which described conduct or misstatements using the phrase "in connection with the purchase or sale" of a covered security. *See* Br. App. at 8a; *see generally United States v. Gonzales*, 520 U.S. 1, 5 (1997) (construing "any" to mean "all"; "the word 'any' has an expansive meaning"); *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258, 278-79 (1992) (O'Connor, J., concurring, joined by White and Stevens, JJ.) (interpreting use of "any person" in RICO to encompass "all" and rejecting contention that the language could "reasonably be read to mean only purchasers and sellers of securities"); *Mobil Oil Exploration v. United Distribution*, 498 U.S. 211, 223 (1991) (interpreting statute concerning regulation of prices for "any natural gas" category as applying to all natural gas categories, "[i]nsofar as 'any' encompases 'all'").

Respondent concedes that the conduct alleged in his complaint relates to "trading practices involving manipulation of the securities markets." Resp. Br. at 8. Respondent does not dispute that his holder claim necessarily involves allegations that defendant's conduct affected the market value of securities or the price at which securities are purchased or sold. Pet. Br. at 21-23, 27-28 (quoting *Basic Inc. v. Levinson* and *SEC v. Texas Gulf Sulphur*). Thus, apart from the question whether the purchaser-seller standing requirement is imported into SLUSA, Respondent does not dispute that his claims otherwise involve allegations of misstatements "in connection with the purchase or sale" of securities. Pet. Br. at 24-27 (citing *SEC v. Zandford*, 535 U.S. 813 (2002)).

Respondent also concedes (at 22) that the "in connection with" language in SLUSA's preemption provision must be accorded the same meaning as in section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b). But he gives short shrift to that plain statutory language, resting his argument instead on two flawed propositions: first, that the *Blue Chip Stamps* purchaser-seller standing rule, which restricts who may bring implied private

rights of action under section 10(b), is a limiting construction of the "in connection with" statutory language that is also used in SLUSA, and second, that the meaning of "in connection with the purchase or sale" is different and narrower in the private, as opposed to civil regulatory or criminal, context. Respondent accordingly contends that Congress intended in SLUSA to import only the so-called more restrictive meaning of "in connection with" as construed by *Blue Chip Stamps* in the context of private damages claims under section 10(b).

Both propositions have been squarely rejected by this Court's decisions. Whatever additional requirements (standing or otherwise) must be satisfied for a plaintiff to bring a judicially implied private right of action under section 10(b), the plain meaning of the statutory text and the scope of *defendant's* conduct that is prohibited by section 10(b) does not vary whether the plaintiff is a private party, the SEC, or a public prosecutor, and most certainly is not *narrower* in the civil, as opposed to criminal, context.

1. Central to Respondent's textual argument is the misguided premise that the purchaser-seller standing limitation adopted by this Court in *Blue Chip Stamps* rested upon an interpretation of the "in connection with the purchase or sale" language of section 10(b). A simple reading of *Blue Chip Stamps* and subsequent case law belies that central premise. *Blue Chip Stamps*, to be sure, analyzed the text and intent of the provision to confirm that a purchaser-seller standing limitation would not be *inconsistent* with the language and intent of Congress. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-36 (1975).

But the bulk of the Court's decision (*see id.* at 737-49) rested on "what may be described as policy considerations . . . to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Id.* at 737; *see also id.* ("[W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5."); *id.* at 739 (considering advantages of purchaser-

seller rule "purely as a matter of policy"); *id.* at 744 ("considering the policy underlying the *Birnbaum* rule"); *id.* at 749 (resting in large part on "considerations of policy" "[t]aken together with the precedential support for the *Birnbaum* rule over a period of more than 20 years"); *id.* at 754-55 (same).

A statutory provision intended principally as a criminal and SEC catch-all antifraud provision – for which the purchaser-seller standing limitation undisputedly does not apply – could not properly have been construed as requiring such a standing limitation for private actions when private actions were not even specifically authorized or legislatively created. As the Court explained:

> [W]e are not dealing here with any private right created by the express language of § 10(b) or of Rule 10b-5. *No language in either of those provisions speaks at all to the contours of a private cause of action for their violation.* . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question. . . . *[W]e believe that practical factors to which we have adverted, and to which other courts have referred, are entitled to a good deal of weight.*

Id. at 748-49 (emphasis added); *see also id.* at 751 n.14 ("[T]he purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under § 10(b) and Rule 10b-5."); *cf. Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 n.7 (1985) ("In this case, *unlike with respect to the interpretation of § 10(b) in Blue Chip Stamps*, we have the plain language of § 2(1) of the 1933 Act in support of our interpretation.") (emphasis added); *Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1, 43 n.31 (1977) (*Blue Chip Stamps* "limited standing under Rule 10b-5 to purchasers or sellers of securities").

One year before SLUSA was enacted, the Court confirmed that *Blue Chip Stamps* was based on "'policy considerations,'" not the language of section 10(b). *United States v. O'Hagan*,

521 U.S. 642, 664-65 (1997) (quoting *Blue Chip Stamps*, 421 U.S. at 737). The Court thus concluded that section 10(b), "as written, does not confine its coverage to deception of a purchaser or seller of securities," *O'Hagan*, 521 U.S. at 651, but instead may be violated "even though the person or entity defrauded is not the other party to the trade," *id.* at 656; *see also* Pet. Br. at 32-33; *Holmes*, 503 U.S. at 285 (O'Connor, J., concurring, joined by White and Stevens, JJ.) ("The purchaser/seller standing limitation . . . does not stem from a construction of the phrase 'in connection with the purchaser or sale of any security.'"); *id.* at 289-90 (Scalia, J., concurring) ("[T]he limitation we approved in *Blue Chip Stamps* was essentially a legislative judgment rather than an interpretative one."); 8 Louis Loss & Joel Seligman, *Securities Regulation* 3721 (3d ed. 2004) ("in connection with" element met if "*someone* buy[s] or sell[s] the security during the period of allegedly fraudulent conduct").

2. Respondent and his *amici* dismiss these clear statements by this Court with a sleight-of-hand: they assert that *O'Hagan* merely confirmed that the *Blue Chip Stamps* purchaser-seller rule "was specific to the implied private right of action under § 10(b) and did not determine the scope of § 10(b) liability in regulatory or criminal enforcement suits." Resp. Br. at 25. Respondent argues, in effect, that the language of § 10(b) has been interpreted to mean one thing in the civil regulatory or criminal context, and to have another, narrower meaning in the private right of action context.

But this contention falls back on the erroneous proposition that *Blue Chip Stamps* purported to rest on a construction of the plain language of section 10(b) and Rule 10b-5, whether in the private civil action context or any other. More fundamentally, the same language of the statute does not mean one thing in one context and a different thing in another context. SLUSA's use of the "in connection with" language thus does not import a more restricted meaning of section 10(b) allegedly applicable in the private right of action context, as distinct from the more expansive meaning set forth in the criminal or regulatory context.

It is a well-established principle of this Court that the same statutory language has the same meaning, notwithstanding the fact that it has multiple applications. *See, e.g., Leocal v. Ashcroft*, 125 S. Ct. 377, 384 n.8 (2004) ("Although here we deal with § 16 in the deportation context, § 16 is a criminal statute, and it has both criminal and noncriminal applications. . . . [W]e must interpret the statute consistently, whether we encounter its application in a criminal or noncriminal context . . . ."); *FCC v. Am. Broad. Co.*, 347 U.S. 284, 296 (1954) ("There cannot be one construction for the [FCC] and another for the [DOJ]. If we should give [the statutory provision] the broad construction urged by the [FCC], the same construction would likewise apply in criminal cases.").[1]

In fact, this Court has consistently construed the 1933 and 1934 Acts across varying civil and criminal contexts. In *Aaron v. SEC*, 446 U.S. 680 (1980), the Court construed section 10(b) of the 1934 Act to include a *scienter* requirement in SEC enforcement proceedings, based on "controlling precedent" that involved a private cause of action for damages. *See id.* at 689-91. In so doing, this Court specifically rejected the argument, embraced by the dissent, that the Court's prior interpretation of section 10(b) in the private damages action was "not a proper guide in construing § 10(b) in the present context of a[n SEC] enforcement action for injunctive relief." *Id.* at 691-95. Instead, the Court concluded: "In our view, the rationale of [the controlling precedent] ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5,

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1. *See also Clark v. Suarez Martinez*, 125 S. Ct. 716, 722-27 (2005) (refusing to give the same statutory provision different meanings that depended on its application to different categories of people defined by the statute, noting "the dangerous principle that judges can give the same statutory text different meanings in different cases"); *Ratzlaf v. United States*, 510 U.S. 135, 143 (1994) ("A term appearing in several places in a statutory text is generally read the same way each time it appears. We have even stronger cause to construe a *single* formulation, here § 5322(a), the same way each time it is called into play.") (citation omitted; emphasis in original); *United States ex rel. Marcus v. Hess*, 317 U.S. 537, 542 (1943) ("[W]e cannot say that the same substantive language has one meaning if criminal prosecutions are brought by public officials and quite a different meaning where the same language is invoked [in a civil *qui tam* suit].").

regardless of the identity of the plaintiff or the nature of the relief sought." *Id.* at 691.[2]

There accordingly is no basis for ascribing to the "in connection with" language contained in section 10(b) and SLUSA's preemption provision a different or narrower meaning in the private action context. To the contrary, preemption under SLUSA is triggered by *allegations* concerning the conduct, regardless of the identities of the private class action claimants, just as the scope of liability under section 10(b) is triggered by the scope of the unlawful conduct rather than the identity of the plaintiff. *See* Pet. Br. at 31 (citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 172-73 (1994); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 64 (1975)).

II. The Asserted Presumption Against Preemption Is Unavailing In This Case

Respondent's and *amici*'s attempt to invoke the "presumption against preemption" is to no effect. Even if such a "presumption" does have weight under this Court's jurisprudence, *see, e.g., Engine Mfrs. Ass'n v. South Coast Air Quality Mgmt. Dist.*, 541 U.S. 246, 256 (2004) (decision of the Court by seven Justices noting that "not all Members of [the] Court agree" on the applicability of a "presumption" in preemption cases, and declining to apply it in that case), it is at most a "canon[] of interpretation" that is not applicable, as here, to "a nonambiguous command to pre-empt." *Bates v. Dow Agrosciences LLC*, 125 S. Ct. 1788, 1801 (2005). Moreover, contrary to Respondent's and his *amici*'s repeated misstatement of the question presented, SLUSA preempts only certain

2. If anything, principles of lenity would dictate a narrower reading of statutory coverage in the criminal context. *See* Pet Br. at 27; SIA Br. at 10-11 & n.6. For this reason, Respondent and *amici*'s distinction of *O'Hagan* simply because it is a criminal case is unavailing. Indeed, lower courts routinely rely upon criminal and SEC enforcement cases in construing the language of section 10(b) in the private civil context. *See, e.g., Foss v. Bear, Stearns & Co.*, 394 F.3d 540, 541-42 (7th Cir. 2005) (citing *Zandford, O'Hagan*, and *Naftalin*); *Grippo v. Perazzo*, 357 F.3d 1218, 1223-24 (11th Cir. 2004) (citing *Zandford*); *Smith v. Am. Nat'l Bank & Trust Co.*, 982 F.2d 936, 942-43 (6th Cir. 1992) (citing *Chiarella* regarding duty to speak); *Polinsky v. MCA Inc.*, 680 F.2d 1286, 1289 (9th Cir. 1982) (citing *Chiarella* regarding duty to speak).

covered *private class actions* under state law involving nationally traded securities, and does not preempt any state law *claims* altogether. The area at issue here – private state law holder class actions involving nationally traded securities – is hardly a longstanding and venerable category of state regulatory activity for which a presumption against preemption is warranted.

1. Where, as here, Congress' intent to preempt is expressly manifested in a statutory provision, Respondent concedes that the Court's task is simply to construe that statute according to its plain language and natural meaning. *See* Resp. Br. at 21 (citing *CSX Transp., Inc. v. Easterwood*); *see also Engine Mfrs.*, 541 U.S. at 256-57 (declining to invoke presumption against preemption where "the language of [an express preemption provision] is categorical"); *Egelhoff v. Egelhoff*, 532 U.S. 141, 151 n.4 (2001) ("Contrary to the dissent's suggestion that the resolution of this case depends on one's view of federalism, . . . we are called upon merely to interpret ERISA."); *Sprietsma v. Mercury Marine*, 537 U.S. 51, 62-70 (2002) (while finding no preemption, the unanimous Court applied express and implied preemption analyses in an area traditionally regulated by the states, recreational boat safety, with no mention of the presumption against preemption).[3]

Indeed, preemption "'is *compelled* whether Congress' command is explicitly stated in the statute's language or implicitly contained in its structure and purpose.'" *FMC Corp. v Holliday*, 498 U.S. 52, 56-57 (1990) (emphasis added) (quoting *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 95 (1983)).

The principal cases in which members of this Court have invoked the so-called "presumption" against preemption underscore the extent to which it is unavailing in this case. In

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3. *See also Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 224 (1992) (making no mention of presumption against preemption and refusing to read express preemption provision narrowly: "our task is simply to ascertain the fair meaning of that term"); *Geier v. Am. Honda Motor Co.*, 529 U.S. 861, 867-86 (2000) (applying express and implied preemption analyses without invoking presumption against preemption, despite strong dissent articulating the presumption).

Bates, the Court mentioned the "duty to accept the reading that disfavors pre-emption" only *after* it had concluded as a matter of statutory construction that most of the asserted state common law damages claims *were* preempted. The Court did not base its holding of no preemption as to the remaining few state law claims upon the so-called "presumption," but instead rested on the plain language of the statutory preemption provision. It held that a contrary holding would read certain words out of the statute and would not present "a plausible alternative reading of" the provision. 125 S. Ct. at 1801; *see also Medtronic, Inc. v. Lohr*, 518 U.S. 470, 484-86 (1996) (interpretation of preemption provision must begin with statutory text; congressional purpose remains the touchstone, and the presumption against preemption is overcome by a "fair understanding of congressional purpose").

Indeed, the *Bates* Court mentioned the presumption against preemption only in the context of noting that the United States argued against preemption of the same claims in earlier separate litigation and switched positions in *Bates*. The Court thus rejected "[t]he notion that FIFRA contains a nonambiguous command" to preempt. 125 S. Ct. at 1801. Here, by contrast, the SEC's interpretation of the broad scope of the "in connection with" language as not restricted by the purchaser-seller standing rule accords with its longstanding practice, *see* Pet. Br. at 26 n.7, 28 n.8, and there is no hint in SEC rulings or this Court's decisions of any ambiguity in this longstanding statutory interpretation.

Even in areas traditionally subject to state regulation, where members of this Court have referred to the presumption against preemption, this Court has dispensed with the presumption where Congress had made its intent clear. As the Court explained in *Egelhoff*, with respect to areas of traditional state regulation such as family law and probate law: "[The presumption against preemption] can be overcome where, as here, Congress has made clear its desire for pre-emption. Accordingly, we have not hesitated to find state family law pre-empted when it conflicts with ERISA or relates to ERISA plans." 532 U.S. at 151; *see also Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 541-42, 547-48 (2001) (identifying advertising as

field of traditional state regulation to which presumption against preemption applied but rejecting "narrow construction" of express preemption provision of "debatable" meaning). In such cases, the "presumption" against preemption is merely a reminder that Congress' intent to preempt should be sufficiently clear in the language, structure and purpose of the statute.

There is no ambiguity here. In SLUSA, Congress enacted a statute for the very purpose of displacing state securities class actions. Preemption was not a supplement to other federal regulatory goals, but instead was the core object of SLUSA. The so-called "presumption against preemption" does not affect the analysis in this case that is driven by the clear text and purpose of SLUSA.

2. Respondent and his *amici* assert that holder class actions preempted by SLUSA have a history of more than 150 years. *See* Resp. Br. at 4-6, 27, 35; States' Br. at 4-7. But of the 12 holders cases they cite that were brought before SLUSA's enactment, none involved a state court class action. One involved a federal court's approval of a class action settlement of purchaser and holder claims. *See Weinberger v. Kendrick*, 698 F.2d 61 (2d Cir. 1982). Of the 11 pre-SLUSA *individual* actions, apparently only one involved nationally traded securities. *See David v. Belmont*, 291 Mass. 450, 197 N.E. 83 (1935). Every other holders' case cited by Respondent or the *amici* was brought after SLUSA's enactment.[4]

Far from constituting a long and venerable history of holders' state law class action jurisprudence over 150 years

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4. Respondent also cites several federal court cases which, applying state law, held that holders of securities may not maintain direct damages actions. *See* Resp. Br. at 43 & nn.48-52. Only four of these were brought before SLUSA's enactment, and none of these four was a class action related to nationally traded securities. *See Arent v. Distribution Sciences, Inc.*, 975 F.2d 1370 (8th Cir. 1992); *Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690 (7th Cir. 1990); *Crocker v. FDIC*, 826 F.2d 347 (5th Cir. 1987); *Chanoff, v. United States Surgical Corp.*, 857 F. Supp. 1011 (D. Conn.), *aff'd mem.*, 31 F.3d 66 (2d Cir. 1994).

that would be displaced by SLUSA, the sporadic and inapposite cases cited by Respondent simply underscore that state law holder class actions are of recent vintage and represent an attempt by the plaintiffs' bar to evade the congressional mandates set forth in the PSLRA. They do not constitute the kind of traditional state activity that merits a "presumption" against preemption.

Respondent and his *amici* further contend that the long existence of state regulatory schemes governing securities, known as Blue Sky laws, counsels against a finding of preemption of holder class actions under SLUSA, and in favor of a presumption against preemption. As one of the *amici* acknowledges, however, Blue Sky laws regulated only *intrastate* concerns. Bulldog Br. at 4-5. Indeed, "[t]he fact that Blue Sky regulation applied only to sales of securities and licensing of persons within the borders of a state mitigated any Commerce Clause concerns." 1 Robert N. Rapp, *Blue Sky Regulation* § 1.02[2] & n.27 (2005) (citing *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557-58 (1917)); *accord Edgar v. MITE Corp.*, 457 U.S. 624, 641 (1982). Moreover, it was the inability of states effectively to regulate nationally traded securities that spawned the need for federal regulation in 1933 and 1934. *See* 1 Louis Loss & Joel Seligman, *Securities Regulation* 193-99 (3d ed. 1998).

Significantly, shortly before the passage of SLUSA, Congress found that even this traditional intrastate regulation was unnecessarily burdensome to the national securities markets and so enacted the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416. The passage of NSMIA ensures that States cannot interfere in the regulation of nationally traded securities by imposing requirements on securities offerings and "as a general rule, designat[es] the Federal government as the *exclusive* regulator of national offerings of securities." H.R. Rep. No. 104-622, at 16 (1996) (emphasis added). Section 18(a) of the 1933 Act unequivocally provides that no state

may require registration or qualification of securities or securities transactions with respect to covered securities, nor may the states conduct merits reviews of offerings or impose requirements on the content of proxy solicitation materials required to be filed with the SEC.

Far from undermining a long history of state regulation of nationally traded securities, SLUSA thus marked the third in a series of major congressional enactments between 1995 and 1998, after the PSLRA and NSMIA, designed to alter the relationship between federal securities law and state law. Indeed, the duality of state and federal court securities litigation to which this Court referred in *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 383 (1996) (cited in Resp. Br. at 4), was based upon a version of section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a), that was specifically amended to except the impact of the preemption provisions under SLUSA.[5]

III. Congress Intended To Provide Defendants With The Protections Of The PSLRA And SLUSA Regardless Of The Identity Of The Plaintiffs

The plain language of SLUSA is dispositive of this case. "[W]e do not resort to legislative history to cloud a statutory text that is clear." *Ratzlaf*, 510 U.S. at 147-48. *Accord Exxon Mobil Corp. v. Allapattah Servs., Inc.*, 125 S. Ct. 2611, 2625-27 (2005). This is especially true where Respondent's citation of isolated snippets from the legislative history, excerpted with abundant ellipses, is simply "an exercise in 'looking over a crowd and picking out your friends.'" *Id.* at 2626 (citation omitted).

Moreover, as the court of appeals below found (Pet. App. 31a-33a) and as the Respondent does not dispute, there is an

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5. *See* 15 U.S.C. § 78bb(a), (f). An identical amendment was added to the analogous provision under section 16(a) of the 1933 Act, 15 U.S.C. § 77p(a) ("*Except as provided in subsection (b)*, the rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity.") (emphasis added).

absence of any congressional discussion in the legislative history of SLUSA concerning the continued viability of state law holder class actions or the applicability of the purchaser-seller standing rule to the scope of preemption. Under these circumstances, congressional silence cannot be the basis for adopting a limiting construction or exception which does not appear on the face of the statute. *See Harrison v. PPG Indus.*, 446 U.S. 578, 592 (1980) ("[I]t would be a strange canon of statutory construction that would require Congress to state in committee reports or elsewhere in its deliberations that which is obvious on the face of a statute."). Particularly because there is *no* longstanding tradition of state law holder class actions that would be displaced by SLUSA, it is not surprising that Congress was silent about the impact of SLUSA's broad preemptive scope upon such claims. *Compare City of Rancho Palos Verdes v. Abrams*, 125 S. Ct. 1453, 1465 (2005) (Stevens, J., concurring) (judges may "take into consideration the fact that a watchdog did not bark in the night" where a construction would make "so sweeping and so relatively unorthodox a change" in the law) (quotation omitted).

The legislative history of SLUSA confirms that Congress considered covered private state law class actions to be inherently susceptible to abuse. It accordingly concluded, as a policy matter, that they should be preempted and removable to federal court even if no corresponding private federal class action remedies are available. It would be anomalous, indeed absurd, to conclude that when Congress used the "in connection with" language in SLUSA – a statute designed to curtail abusive securities fraud claims and prevent them from being filed under state law – it intended to revive, in class action format, the very holder suits held by this Court in *Blue Chip Stamps* to be particularly susceptible to abuse, and to preempt only suits by purchasers and sellers.

1. There is no support in the legislative history, as Respondent repeatedly contends (at 1, 20, 30-34, 37-38), for the proposition that Congress intended to preempt only state

law class actions asserting federally cognizable claims. To the contrary, the enacted findings of SLUSA state more broadly that "it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities." SLUSA § 2(5), 112 Stat. at 3227. In any event, "[t]he fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning." *Union Bank v. Wolas*, 502 U.S. 151, 158 (1991) (quoted in *Lockhart v. United States*, 126 S. Ct. 699, 702 (2005)).

In fact, it was the weaker claims (those that would not be cognizable under the federal securities laws) that were increasingly being brought in state court as class actions and that Congress sought to curtail. As Senator Dodd, one of SLUSA's co-sponsors, explained:

> My fear is that the State court filings represent those suits that aren't strong enough to stand up in Federal court. Securities class actions were almost unheard of in State court prior to 1995; it is reasonable then to attribute the increase in both 1996 and 1997 to weaker, and frequently abusive, claims finding a more comfortable home in State court than in Federal court.

1997 Oversight Hearing, at 3-4 (Opening Statement of Sen. Dodd).[6] Indeed, in words remarkably similar to the policy

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6. Respondent mis-cites Senator Dodd for the proposition that the legislative history "unambiguous[ly]" states that Congress intended "to leave unaffected traditional state-law securities class action suits" Resp. Br. at 32, 37 (citing 143 Cong. Rec. S10477 (daily ed. Oct. 7, 1997) (Statement of Sen. Dodd)), yet Respondent's brief simply uses ellipses (at 32) to substitute "state law securities class action[s]" for the exceptions Senator Dodd actually described: that the bill "does not affect individual actions in State court; it does not protect penny stocks or delisted securities, rollups, or securities sold only within a single State; it does not protect bad brokers or investment advisors; it does not impact on State regulators." 143 Cong. Rec. S10477. Senator Dodd declared in the sentence immediately preceding the snippet

(Cont'd)

arguments posited in Respondent's brief, then-SEC Chairman Levitt testified that:

> The practical effect of passage [of S.1260] will be that State securities laws will be inapplicable in most class actions, whether brought in Federal or State court. The governing law will be Federal law. Because a number of States allow claims that cannot be brought under Federal law and because it is not always cost-effective for plaintiffs to proceed individually, the bill will preclude relief as a practical matter for some small investors who may have been defrauded.
>
> As a result, certain investor protection laws available at the State level, which the Commission favors, would no longer be available.

1997 Hearing on S. 1260, at 47 (Prepared statement of Arthur J. Levitt, Jr., Chairman and Isaac C. Hunt, Jr., Commissioner, SEC); *see also, e.g.*, Pet. Br. at 46-48 & n.16; H.R. Rep. No. 105-640, at 46-51 (1998) (dissenting views highlighting that some aggrieved investors will be left with no class remedies in federal or state court); 144 Cong. Rec. S4795 (statement of Sen. Bryan) (same); *Hearing on H.R. 1689*, at 24 (Prepared statement of Arthur Levitt).

(Cont'd)

quoted by Mr. Dabit that "[t]he principle of national treatment for national securities trading or national exchanges is as solid for legislation on securities litigation as it was for securities regulation," *id.* (referring to the prior enactment of NSMIA), and continued that class actions involving nationally traded securities were only "appropriately heard on the federal level" and that "if our markets are to remain ahead of those in London, Frankfurt, Tokyo or Hong Kong, we must create uniformity and certainty." *Id. Compare also, e.g., 1997 Hearing on S. 1260*, at 2 (Opening statement of Sen. Gramm) (explaining that SLUSA basically says that "for class action suits, and class action suits only, where you are dealing with a stock that is traded nationally, so there is clearly an overriding national interest, that those suits have to be filed in Federal court.") *with* Resp. Br. at 31.

Thus, Congress recognized that with SLUSA, certain remedies would be foreclosed. Although it added a few exceptions to SLUSA preemption in response to the concerns of Mr. Levitt and others, Congress did not add holder claims to its exceptions or exemptions from SLUSA preemption.

2. A full reading of the Conference Report and other isolated excerpts of legislative history cited by Respondent (Resp. Br. at 31-32 & n.37) reveals that Congress intended to prevent plaintiffs from using state courts to pursue a wide range of abusive securities class actions which, prior to the passage of the PSLRA, were all but non-existent in the state courts. *See* H.R. Conf. Rep. No. 105-803, at 14-15 (1998) (stating Congress' intent to prevent plaintiffs from exploiting "differences between Federal and State laws" by preempting state law securities class actions more broadly). *Compare* Resp. Br. at 31 (citing the Conference Report for the proposition that "Congress determined that the increase [in state court filings] was due to plaintiffs with federally cognizable claims leaving federal court and filing those same claims under state law").

Congress heard testimony that differences between federal and state law are significant and susceptible to abuse. Even if a plaintiff satisfies the *Blue Chip Stamps* standing requirement and PSLRA's procedural requirements, there are numerous other substantive reasons why such a plaintiff may still not be able to assert a federally cognizable securities claim, including (i) the expiration of the shorter federal statute of limitations; (ii) the absence of a federal claim for aiding and abetting liability; (iii) the substantive protection of the PSLRA's safe harbor for forward-looking statements; (iv) the requirement of *scienter* and allegations of fraud rather than mere negligence; and (v) the need to allege and prove loss causation. *See, e.g., 1998 Hearing on S. 1260*, at 18 (testimony of Professor Painter warning Congress that in light of these differences some plaintiffs after SLUSA will be left without a class action remedy, noting that under federal law: "*You cannot sue if you did not yourself personally buy,*

or if you did not yourself personally sell securities, under the Blue Chip Stamps case.") (emphasis added).[7] *Compare Resp. Br.* at 36 (acknowledging differing elements of state law causes of action).

Yet under Respondent's reading, plaintiffs barred from federal court for these substantive reasons would remain free to bring state class actions. For example, if SLUSA would not preempt state law securities class actions asserting negligence in the making of forward-looking statements, then the protections of the PSLRA safe harbor "actual knowledge" requirement, *see* 15 U.S.C. § 78u-5(c)(1)(B), would be eviscerated. Such a result would run directly contrary to congressional intent. *See* 143 Cong. Rec. S10476 (daily ed. Oct. 7, 1997) ("[T]he prospect of State litigation where there is no safe harbor for forward looking statements is right now having a chilling effect upon corporate disclosure of projections and other forward looking information.") (Statement of Sen. Dodd).

3. Neither Congress nor Petitioner ever stated that SLUSA was intended to create "absolute uniformity." Resp. Br. at 36. It was the prerogative of Congress to preempt only class actions based on its explicit recognition that class actions impose a unique set of harms that individual actions do not. If Respondent disagrees with the congressional wisdom behind the enactment of SLUSA, legislative action is the proper recourse. Indeed, Respondent devotes a large portion of his brief to setting forth policy arguments that were already considered and rejected by Congress, and that apply equally

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7. Remarkably, the *amici* States cite Professor Painter's testimony as purported support that SLUSA created an exception for those plaintiffs that cannot meet the *Blue Chip Stamps* standing requirement. (States' Br. at 6, 10.) But despite his warning that the operation of *Blue Chip Stamps* together with SLUSA might mean that some investors would be deprived of both a federal and state class action remedy, Congress did not choose to state – either in the history or language of SLUSA – that state law holder class actions would remain after SLUSA as viable remedies for plaintiffs who do not satisfy the *Blue Chip Stamps* standing rule applicable to federal claims.

to state law class actions by purchasers and sellers, which indisputably are preempted by SLUSA.[8]

In particular, he argues in favor of allowing private investor class action remedies as an important deterrent to corporate malfeasance and as the only available remedies to many investors. But Congress expressly determined that many other effective remedies remain even with SLUSA preemption. As noted in the statute's findings, in addition to actions by state regulators, individual actions as well as the excepted actions (including derivative actions) remain as available private enforcement. *See* SLUSA § 2(4)-(5), 112 Stat. at 3227. Further, the modern trend toward arbitrating securities claim provides investors with available, non-preempted remedies.[9]

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8. Respondent's citation of Senator Dodd's statement (at 34), to the effect that the private litigation system was "important . . . in maintaining the integrity of our capital markets," actually undermines his argument because in the very next sentence Senator Dodd stated,

> It is precisely because of the importance of this system that the depths to which it had sunk by 1995 was so very troubling. The system was no longer a mechanism for aggrieved investors to seek justice and restitution, but was instead a means for enterprising attorneys to manipulate its procedures for their own considerable profit and to the detriment of legitimate companies and investors across the nation.

143 Cong. Rec. S10476; *compare* Resp. Br. at 34. *Compare also, e.g.*, Resp. Br. at 35 n.38 (excerpted Statement of Sen. D'Amato) *with* 144 Cong. Rec. S12445 (daily ed. Oct. 13, 1998) ("But we should not condone little more than a judicially sanctioned shakedown that only benefits strike lawyers" and "however, companies should not be forced to settle cases that have no merit just to minimize their losses.").

9. Indeed, Respondent's primary example of investors relying to their detriment on allegedly biased research advice is a settlement Merrill Lynch paid in an *arbitration* brought by an individual investor. (Resp. Br. at 10, 45 n.53.) "[A]rbitration in the securities industry as mandated by the U.S. Supreme Court has resulted in more, not less, protection for the investing public." Lewis D. Lowenfels & Alan R. Bromberg, *Beyond Precedent: Arbitral Extensions of Securities Law*, 57 Bus. Law. 999, 1008 (2002). This is consistent with this Court's recognition of the public policy favoring arbitration. *See, e.g., Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 232-34 (1987).

Moreover, Congress gave far more credit to federal and state regulators in enforcing the securities laws than does Respondent. Respondent states that "[i]n April 2002, *before the SEC took action*, Dabit, a former Merrill Lynch broker, filed this suit in federal court" Resp. Br. at 15 (emphasis added). Of course, Mr. Dabit's action was only commenced *after* the New York Attorney General's investigation was made public. Moreover, in an effort to denigrate the efforts of regulators, Respondent criticizes the regulators' recovery of approximately $2 billion on behalf of mutual fund shareholders in so-called "market timing" cases. *See* Resp. Br. at 40-41; ICI *Amicus* Br. at 9 n.2 (in 2004, "the SEC and state regulators secured roughly $2.5 billion); *compare* 144 Cong. Rec. H6057 (daily ed. July 21, 1998) (Rep. Tauzin noting that 94% of securities class actions brought by the private securities class action bar were settled for "10 cents on the dollar").[10]

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10. Despite the amount of ink spilled on the subject of market timing by Respondent and his amici, neither the initial nor the amended complaint contained any allegations concerning market timing. Respondent's assertion (at 48) that he "may be able to plead" a state-law market timing claim or a host of other state law theories is pure speculation and should not be the basis of an advisory opinion by this Court. In any event, mutual fund investors have asserted other civil remedies for alleged market timing. *See Kircher v. Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005) ("[M]ost of the approximately 200 filed against mutual funds alleging [market timing] . . . have been filed in federal court under Rule 10b-5"), *petition for cert. filed* (U.S. Sept. 29, 2005) (No. 05-409). Mutual fund investors have also sought to bring derivative actions. *See In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 873 (D. Md. 2005) (dismissing derivative claims for failure to meet demand requirement). They have also brought individual actions. What they may not do is bring a state-law class action that is precluded by the plain terms of SLUSA. *See Kircher*, 403 F.3d at 483-84.

CONCLUSION

The decision of the court of appeals should be reversed in relevant part with instructions that the holder claims should be dismissed with prejudice.

Respectfully submitted,

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In the Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
PETITIONER

v.

SHADI DABIT

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, preempts state-law class action claims brought on behalf of persons who held or retained, but did not purchase or sell, securities based upon allegedly fraudulent statements or omissions.

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In the Supreme Court of the United States

No. 04-1371

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
PETITIONER

v.

SHADI DABIT

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

INTEREST OF THE UNITED STATES

The United States, through the Securities and Exchange Commission (Commission) and the Department of Justice (Department), administers and enforces the federal securities laws. This case involves the extent to which the Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227, preempts private securities fraud class actions brought under state law. Legitimate private actions are an essential supplement to civil enforcement actions and criminal prosecutions brought by the Commission and the Department, but the availability of the class action mechanism and liberal discovery rules create a substantial risk of abusive and counterproductive "strike" suits.

The United States has a strong interest in ensuring that the principles applied in private securities fraud actions promote the purposes of the securities laws without unduly burdening the efficient operation of the securities markets.

In addition, Congress tied the scope of preemption under SLUSA to the scope of conduct prohibited by the statutes and Commission regulations prohibiting securities fraud. Pet. App. 17a-21a. The United States thus has an especially strong interest in the correct interpretation of those provisions, including the "in connection with" requirement at issue in this case.

STATEMENT

1. Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act) makes it unlawful to "use or employ, in connection with the purchase or sale of any security * * *, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. 78j(b). The Commission's Rule 10b-5 implements Section 10(b) by declaring it unlawful, "in connection with the purchase or sale of any security," to "employ any device, scheme, or artifice to defraud"; "make any untrue statement of a material fact or * * * omit to state a material fact necessary in order to make the statements made * * * not misleading"; or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5.

The Commission may bring a civil enforcement action against "any person" who "violated any provision of [the 1934 Act]" or "the rules or regulations thereunder," 15 U.S.C. 78u(d)(3)(A), and the Department may bring criminal prosecutions for willful violations, 15 U.S.C.

78ff(a) (Supp. II 2002). See also 15 U.S.C. 78u(d)(1) (Supp. II 2002) (authorizing Commission actions for prospective injunctive relief whenever a person is "about to engage" in a violation). Section 10(b) has also been construed to afford an implied right of action to private parties, but this Court has held that the private right of action does not extend to individuals who "neither purchased nor sold any of the offered shares." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 725 (1975).

Out of concern that the salutary purposes of private securities litigation were being "undermined by * * * abusive and meritless suits," H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995), Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737. That statute adopted numerous reforms applicable to actions brought under the 1934 Act, such as a safe harbor for forward-looking statements, heightened pleading standards, an automatic stay of discovery, and provisions governing the appointment of class action plaintiffs and counsel. See 15 U.S.C. 78u-4(b), 78u-5.

By 1998, however, Congress observed a rise, in response to the PSLRA, of class actions brought in state courts based on state-law claims, which "prevented [the PSLRA] from fully achieving its objectives" of "prevent[ing] abuses in private securities fraud lawsuits." SLUSA § 2(1)-(3), 112 Stat. 3227. Congress therefore found it "appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits." SLUSA § 2(5), 112 Stat. 3227. To that end, Congress directed that "[n]o covered class action based

upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging," among other things, "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." SLUSA § 101(b), 112 Stat. 3230, 15 U.S.C. 78bb(f)(1)(A).

2. Respondent, a former broker of petitioner's, filed suit in the United States District Court for the Western District of Oklahoma alleging state-law claims for breaches of fiduciary duty and the covenant of good faith and fair dealing. Pet. App. 4a-5a. Respondent alleged that petitioner "issued falsely favorable reports" about certain stocks "in an effort to encourage widespread purchasing of these stocks and to artificially support the stocks['] prices." J.A. 31a. After the alleged manipulation ceased, the stock prices dropped, leaving those "who purchased these stocks at manipulation-inflated prices with substantial losses." J.A. 29a. Respondent sought to represent a class of petitioner's brokers who "purchased" the relevant stocks and were damaged thereby. J.A. 41a.

The district court dismissed the complaint as preempted by SLUSA because it alleged misrepresentations in connection with the purchase of securities. J.A. 49a. The court granted leave to re-plead, however, because it was "conceivable that claims based on wrongfully-induced holding could be pleaded." *Ibid.*

Respondent filed an amended complaint that generally refrains from using the words "purchase" and "sale," but alleges the same scheme to "manipulate the price of [certain] stocks, causing these stocks to trade at artificially inflated prices." J.A. 53a. The class defini-

tion is limited to brokers who "held" the stocks and were damaged thereby. J.A. 64a.

After the Judicial Panel for Multi-District Litigation transferred this case to the Southern District of New York, that court dismissed the amended complaint. Pet. App. 53a-55a. The court explained that respondent's claims are "based on the very same series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court" and "fall squarely within SLUSA's ambit." *Id.* at 55a.

3. The court of appeals vacated in part and remanded. Pet. App. 1a-52a. Noting that SLUSA preempts claims based on misrepresentations "in connection with the purchase or sale" of securities, the court began its analysis with the recognition that "the meaning of 'in connection with' under SLUSA is coterminous with the meaning of the nearly identical language of § 10(b) of the [1934 Act] and its corresponding Rule 10b-5." Pet. App. 3a. In construing the meaning of that phrase, however, the court relied on this Court's holding in *Blue Chip*, *supra*, that persons who neither purchased nor sold securities lack standing to pursue a private right of action under Section 10(b) or Rule 10b-5. Pet. App. 27a-30a. The court recognized that "[t]he limitation on standing to bring private suit for damages" under *Blue Chip* "is unquestionably a distinct concept from the general statutory or regulatory prohibition on fraud in connection with the purchase or sale of securities." *Id.* at 27a. Nonetheless, "[b]ecause *only* purchasers and sellers have a federal private damages remedy," the court concluded that "Congress meant to import the settled standing rule along with the 'in connection with' phrase as a substantive standard," and thereby ex-

empted claims of non-purchasers and non-sellers from preemption. *Id.* at 28a.

The court of appeals also relied on an "assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." Pet. App. 30a-31a (quoting *City of Milwaukee* v. *Illinois*, 451 U.S. 304, 316 (1981)). It determined that Congress had not manifested such a purpose because, although "[t]he legislative history * * * generally indicates a broad preemptive intent," it "contains no specific mention of holding claims or other non-purchaser/non-seller claims." *Id.* at 31a.

Finally, the court of appeals held that respondent's class action claims are preempted in part. "[C]laims of brokers who purchased the stock during the class period in reliance on the misrepresentations" were held to be preempted, while claims based on holding (but not purchasing or selling) stocks were held not to be preempted. Pet. App. 41a. Because the amended complaint does not distinguish between the two sets of claims, the court of appeals remanded with instructions to dismiss all such claims without prejudice to repleading the non-preempted claims. *Id.* at 42a-43a.

SUMMARY OF ARGUMENT

SLUSA preempts state-law class action claims alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. 78bb(f)(1)(A). The court of appeals correctly held that "the meaning of 'in connection with' under SLUSA is coterminous with the meaning of the nearly identical language of § 10(b) of the [1934 Act] and its corresponding Rule 10b-5." Pet. App. 3a. Because

respondent alleges that petitioner made misrepresentations that inflated the prices at which securities were bought and sold, his claims fall well within the scope of Rule 10b-5 and are therefore preempted by SLUSA.

The court of appeals nonetheless held that respondent could avoid preemption by "exclud[ing] from the class claimants who purchased in connection with the fraud." Pet. App. 43a. That holding is incorrect because it conflates the question of standing to sue with the question of the conduct alleged. Preemption under SLUSA turns on whether the defendant allegedly committed fraud in connection with the purchase or sale of securities, not whether the plaintiff or class members themselves purchased or sold securities. Under *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), the latter inquiry determines whether a particular plaintiff has standing to sue, but not whether the defendant committed fraud in connection with the purchase or sale of securities.

The court of appeals further erred by relying on an "assumption" of non-preemption and a perceived absence of relevant legislative history. Because securities markets and transactions have long been regulated by the federal government, no such "assumption" applies to SLUSA's express preemption provision. In any event, SLUSA's text overcomes any applicable assumption by clearly and manifestly tying its preemptive effect to the scope of Rule 10b-5's substantive prohibition against securities fraud. The legislative history confirms that Congress intended to apply uniform federal standards to all securities fraud class actions except those it expressly exempted. The uniformity that Congress intended to achieve would be illusory if the uniform federal standards were not binding on plaintiffs who held,

rather than purchased or sold, an affected security during the period of alleged fraud. Under the court of appeals' theory, state-law class actions could proceed in virtually every case of alleged fraud, because it is generally possible in class actions to allege that the same fraudulent conduct injured purchasers and holders alike.

Indeed, the decision below would have the perverse effect of reading a law designed to eliminate abusive and meritless lawsuits to preserve the suits most likely to be abusive and meritless. If any set of plaintiffs were to be exempted from preemption, it would not be those who neither purchased nor sold securities. *Blue Chip* denies standing to such plaintiffs precisely because their suits present an especially high risk of abuse in light of the relative ease of alleging, and difficulty of disproving, that a plaintiff relied on public representations in *not* purchasing or selling a security. Construing *Blue Chip* to immunize "holder" class actions from SLUSA preemption would contravene the intent of Congress and the policies recognized by this Court in *Blue Chip* by permitting a particularly abusive category of state-law class actions to escape SLUSA's reach.

ARGUMENT

THERE IS NO PURCHASER/SELLER LIMITATION ON THE SCOPE OF SLUSA PREEMPTION

In pertinent part, SLUSA provides that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging * * * a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. 78bb(f)(1)(A). As the court of appeals recognized, there is no dispute that this

case is a "covered class action" (see 15 U.S.C. 78bb(f)(5)(B)(i)) based on state common law claims (for breach of fiduciary duty and the duty of good faith and fair dealing, see Pet. App. 6a), involving securities covered by SLUSA (because they are traded on national exchanges, see 15 U.S.C. 78bb(f)(5)(E), 77r(b)(1)). See Pet. App. 16a-17a.

Nor is there any dispute that the amended complaint alleges misrepresentations. See Pet. App. 17a. Instead, the question is "whether these purported misrepresentations were alleged to be 'in connection with the purchase or sale' of the covered securities." *Ibid.* Because the amended complaint alleges as a key premise of respondent's claims that the misrepresentations caused stocks to trade at inflated prices, the misrepresentations were plainly made "in connection with the purchase or sale" of securities—*regardless* of whether this particular plaintiff class bought or sold securities in connection with the misrepresentations.

A. The Key Statutory Phrase "In Connection With The Purchase Or Sale" Of A Security Has The Same Meaning In SLUSA That It Has In Section 10(b) And Rule 10b-5

As the court of appeals correctly concluded, "the meaning of 'in connection with' under SLUSA is coterminous with the meaning of the nearly identical language in § 10(b) of the [1934 Act] and its corresponding Rule 10b-5." Pet. App. 3a. "In using the phrase 'in connection with the purchase or sale of a covered security,' Congress * * * was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits." *Riley* v. *Merrill Lynch, Pierce,*

Fenner & Smith, Inc., 292 F.3d 1334, 1342-1343 (11th Cir.), cert. denied, 537 U.S. 950 (2002); accord Pet. App. 20a-21a; *Disher* v. *Citigroup Global Mkts. Inc.*, 419 F.3d 649, 654 (7th Cir. 2005); *Rowinski* v. *Salmon Smith Barney Inc.*, 398 F.3d 294, 299 (3d Cir. 2005). When, as here, "administrative and judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its administrative and judicial interpretations as well." *Bragdon* v. *Abbott*, 524 U.S. 624, 645 (1998); see *NLRB* v. *Amax Coal Co.*, 453 U.S. 322, 329 (1981); *Lorillard* v. *Pons*, 434 U.S. 575, 580-581 (1978).

Accordingly, "[e]very court of appeals to encounter SLUSA has held that its language has the same scope as its antecedent in Rule 10b-5." *Kircher* v. *Putnam Funds Trust*, 403 F.3d 478, 482 (7th Cir. 2005), petition for cert. pending, No. 05-409 (filed Sept. 29, 2005); see Pet. App. 19a-20a; *Disher*, 419 F.3d at 654; *Rowinski*, 398 F.3d at 299; *Riley*, 292 F.3d at 1342-1343; *Green* v. *Ameritrade, Inc.*, 279 F.3d 590, 597 (8th Cir. 2002). As the court of appeals noted, both parties to this case have agreed with those holdings. Pet. App. 17a, 26a; see Pet. 13; Br. in Opp. 12-13; Resp. C.A. Br. 19. The conclusion is inescapable that the "in connection with" requirement in SLUSA has the same meaning as the corresponding phrase in Section 10(b) and Rule 10b-5.

B. The Amended Complaint Alleges Fraud "In Connection With" The Purchase And Sale Of Securities

Under the standards governing Rule 10b-5 actions, the amended complaint alleges numerous misrepresentations and omissions "in connection with the purchase or sale of a covered security." 15 U.S.C. 78bb(f)(1).

1. Rule 10b-5 is construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *SEC* v. *Zandford*, 535 U.S. 813, 819 (2002) (quoting *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972)); accord *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 10-12 & n.7 (1971); Pet. App. 22a. It prohibits not only "garden variety" fraud, but "*all* fraudulent schemes in connection with the purchase or sale of securities." *Superintendent of Ins.*, 404 U.S. at 11 n.7 (quoting *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

Under Rule 10b-5, all misrepresentations "touching" (*Superintendent of Ins.*, 404 U.S. at 12-13) or "coincid[ing]" (*Zandford*, 535 U.S. at 825) with securities transactions are "in connection with" them, such as when a misrepresentation and a sale are "part of the same fraudulent scheme," *Alley* v. *Miramon*, 614 F.2d 1372, 1378 n.11 (5th Cir. 1980) (Wisdom, J.), or otherwise "[a]re not independent events," *Zandford*, 535 U.S. at 820. See *United States* v. *O'Hagan*, 521 U.S. 642, 655-656 (1997); Pet. App. 23a. Thus, Rule 10b-5 is violated "whenever [false] assertions are made * * * in a manner reasonably calculated to influence the investing public" in their decisions regarding the purchase or sale of securities. *SEC* v. *Texas Gulf Sulfur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); accord, *e.g.*, *McGann* v. *Ernst & Young*, 102 F.3d 390, 393-394 (9th Cir. 1996) (citing cases), cert. denied, 520 U.S. 1181 (1997).

2. The amended complaint alleges that petitioner employed "the hallmarks of stock manipulation" in order to "caus[e] [certain] stocks to *trade* at artificially inflated prices." J.A. 53a (emphasis added). According to the amended complaint, petitioner's "ratings, reports,

and recommendations regarding [certain] stocks were false and contained misleading statements." J.A. 59a. Those allegedly false representations included "buy recommendations" and "strong buy recommendations." J.A. 62a, 64a; see J.A. 63a. In order to mislead "not only investors who were brokerage customers * * * but also individual investors," petitioner "continually promoted the * * * [s]tocks in the press, on television and the internet." J.A. 63a. "[T]hese deceptive reports were disseminated * * * in an effort to artificially support the stocks['] prices." J.A. 54a.

The amended complaint further alleges that petitioner and its agents "traded against [petitioner's] published research recommendations"—*i.e.*, sold the stocks while encouraging others to buy them. J.A. 54a; see J.A. 64a. At the same time, petitioner allegedly "refus[ed] to execute * * * [its customers'] orders to sell these stocks." J.A. 54a. "As a result of [petitioner's] efforts, * * * [affected] companies were better able to use their stock as currency in transactions." J.A. 55a.

Those allegations not only assert fraud coinciding with securities transactions, which is sufficient under *Zandford*, they assert that petitioner succeeded in "causing * * * stocks to trade"—*i.e.*, to be purchased and sold—"at artificially inflated prices." J.A. 53a; see *O'Hagan*, 521 U.S. at 664. Petitioner's alleged selling of the securities at fraudulently inflated prices likewise constitutes fraud in connection with the purchase or sale of securities. See *Wharf (Holdings) Ltd.* v. *United Int'l Holdings, Inc.*, 532 U.S. 588, 596 (2001).

3. Even if the amended complaint had not included express references to trading and selling, it would still have alleged fraud in connection with the purchase or sale of securities. As the court of appeals held, preemp-

tion turns on the "substance" of the allegations, not whether the complaint uses any particular terminology. Pet. App. 16a; see, *e.g.*, *Miller* v. *Nationwide Life Ins. Co.*, 391 F.3d 698, 702 (5th Cir. 2004); *Dudek* v. *Prudential Sec., Inc.*, 295 F.3d 875, 879-880 (8th Cir. 2002). A contrary approach "would allow artful pleading to undermine SLUSA's goal of uniformity—a result manifestly contrary to congressional intent." *Rowinski*, 398 F.3d at 300.

As the Third Circuit explained in a materially identical case, the scheme alleged by respondent "necessarily 'coincides' with the purchase or sale of securities" because "[f]or [it] to work, investors must purchase the misrepresented securities." *Rowinski*, 398 F.3d at 302 (quoting *Zandford*, 535 U.S. at 825); see *Disher*, 419 F.3d at 655 (holding materially identical claims preempted by SLUSA). If the alleged fraudulent misrepresentations or omissions did not lead investors to purchase the affected securities at inflated prices, the price inflation that is an *essential component* of the alleged fraudulent scheme and respondent's alleged injury simply could not occur.[1] Thus, claims like those at issue here are preempted even when they are artfully drafted to disguise their necessary relationship to the purchase or sale of securities.[2]

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[1] Although the alleged fraud in this case involved a manipulation, publicly disseminated fraudulent representations concerning a publicly traded security would affect market purchases and sales irrespective of whether there were a manipulation.

[2] This case therefore does not require the Court to explore the outer limits of the "in connection with" requirement. The Court need not determine, for example, whether that requirement could be satisfied by fraud that did not induce any investors to purchase or sell securities, but instead induced them only to hold securities they already owned.

C. The "In Connection With" Requirement Is Satisfied Regardless Of Whether Respondent Or The Class Members Purchased Or Sold Securities

Although respondent's amended complaint plainly alleges fraud "in connection with the purchase or sale" of covered securities, the court of appeals held that respondent could avoid preemption by "exclud[ing] from the class claimants who purchased in connection with the fraud and who therefore could meet the standing requirement for maintenance of a 10b-5 action." Pet. App. 43a. In other words, the court concluded that SLUSA does not preempt claims that allege fraudulent misrepresentations in connection with the purchase or sale of securities if the claims are brought by people who lack standing to bring Rule 10b-5 actions because they did not purchase or sell securities.

That conclusion is incorrect. By its plain text, SLUSA preempts class actions alleging misrepresentations or omissions "in connection with the purchase or sale" of securities, regardless of whether the plaintiff class would have standing to pursue that violation under federal law. The court of appeals' contrary holding would open a gaping and illogical loophole by permitting potentially the *most* abusive securities class actions to escape SLUSA and the PSLRA, contrary to Congress's expressed intent to require such class actions to proceed only under uniform federal standards.

See SEC Br. at 6, 16-17, *Blue Chip*, *supra*. Nor need the Court determine whether or under what circumstances the requirement could be satisfied by brokers' misrepresentations to their customers relating to the customers' brokerage accounts. See *Zandford*, 535 U.S. at 819, 825 n.4; *Rowinski*, 398 F.3d at 301-302.

1. *The* Blue Chip *purchaser/seller rule does not apply to the determination whether a fraud is "in connection with" the purchase or sale of a security*

Neither Section 10(b) nor Rule 10b-5 affords an express private right of action. See *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 748-749 (1975). Although this Court has long recognized an implied right of action for private parties, see, *e.g.*, *Superintendent of Ins.*, 404 U.S. at 13 n.9, it has held that the implied right of action does not extend to individuals who "neither purchased nor sold any of the offered shares," including those who "allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material." *Blue Chip*, 421 U.S. at 725, 737-738.

But whether a particular plaintiff has standing to pursue a private right of action is an altogether different question from whether a defendant violated the law. See, *e.g.*, *Cannon* v. *University of Chicago*, 441 U.S. 677, 688 (1979). The *Blue Chip* Court repeatedly emphasized that its holding applies only to standing and is not a limitation on the scope of Rule 10b-5's prohibition against fraud in connection with the purchase or sale of a security. Accordingly, the *Blue Chip* purchaser/seller rule is irrelevant in determining the coverage of the "in connection with" requirement.

Indeed, the *Blue Chip* Court analyzed the language of Section 10(b) and Rule 10b-5, including the "in connection with" requirement, and chose *not* to rest its decision on a textual foundation because "[n]o language in either of those provisions speaks at all to the contours of a private right of action." 421 U.S. at 749; see *id.* at 733-737. Instead, the Court decided—"as a matter of policy"—that extending the implied right of action to plain-

tiffs who neither purchased nor sold securities in reliance on an alleged violation would present an unwarranted "danger of vexatious litigation" in light of the ease of alleging, but difficulty of disproving, that a plaintiff had relied on public statements in *not* taking action. *Id.* at 739, 740; see *id.* at 739-749. Thus, "*Blue Chip Stamps* came out as it did not because § 10(b) and Rule 10b-5 are limited to situations in which the plaintiff itself traded securities, but because a private right of action to enforce these provisions is a judicial creation and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm." *Kircher*, 403 F.3d at 483; see *SEC* v. *Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *United States* v. *Newman*, 664 F.2d 12, 17 (2d Cir. 1981); Pet. App. 24a-25a.

Indeed, the *Blue Chip* Court implicitly recognized that the substantive coverage of Rule 10b-5 extends farther than the universe of suits brought by private plaintiffs with standing. The Court acknowledged that "a disadvantage" of its policy-based standing rule is that it "prevents some deserving plaintiffs from recovering damages which have in fact been caused *by violations of Rule 10b-5*." 421 U.S. at 738 (emphasis added). The Court later reiterated that its rule "undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5." *Id.* at 743. The Court thus made clear that "[t]he purchaser/seller standing limitation * * * does not stem from a construction of the phrase 'in connection with the purchase or sale of any security,'" but instead relates solely to the standing of private plaintiffs, and that the scope of private lawsuits is narrower then the substantive scope of the "in connection with" prohibition. *Holmes* v. *Securities Investor*

Prot. Corp., 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and in the judgment); see *id.* at 289-290 (Scalia, J., concurring in the judgment); *O'Hagan*, 521 U.S. at 664-665; *SEC* v. *National Sec., Inc.*, 393 U.S. 453, 467 n.9 (1969) (distinguishing between the "coverage" of Rule 10b-5 and the "standing" of private plaintiffs).

The *Blue Chip* Court underscored those points by explaining that its "purchaser-seller rule imposes no limitation on the standing of the SEC." 421 U.S. at 751 n.14; accord *O'Hagan*, 521 U.S. 642, 664-665 (1997); *United States* v. *Naftalin*, 441 U.S. 768, 774 n.6 (1979); *National Sec.*, 393 U.S. at 467 n.9; *In re Engelman*, 52 S.E.C. 271, 283 n.43 (1995) ("The purchaser-seller standing requirement does not apply to Commission-instituted cases."). In a suit for civil penalties or a criminal prosecution, the government must establish that the defendant "violated" Rule 10b-5, including its "in connection with" requirement. 15 U.S.C. 78u(d)(3)(A); see 15 U.S.C. 78ff(a) (Supp. II 2002). The government's ability to pursue such actions even when a private plaintiff would be barred by the *Blue Chip* standing rule necessarily means that the "in connection with" and standing inquiries are distinct. As Judge Easterbrook explained for the Seventh Circuit, the government's "[i]nvocation of [Rule 10b-5] does not depend on proof that the agency or the United States purchased or sold securities; instead the 'in connection with' language ensures that the fraud occurs in securities transactions rather than some other activity." *Kircher*, 403 F.3d at 483; cf. *O'Hagan*, 521 U.S. at 660 ("§ 10(b) refers to 'the purchase or sale of any security,' not to identifiable purchasers or sellers of securities").

2. ***SLUSA's text expressly ties preemption to the scope of Rule 10b-5's "in connection with" requirement, not to whether a particular plaintiff would have standing to sue for a violation of Rule 10b-5***

Because the *Blue Chip* purchaser/seller rule is a judicially crafted, prudential standing requirement that is premised on policy grounds rather than an interpretation of the statutory "in connection with" requirement, it does not limit the scope of that statutory phrase. The court of appeals appeared to recognize as much when it stated that *Blue Chip*'s "limitation on standing to bring private suit[s] for damages * * * is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities," and "should not be conflated with the question of whether the 'in connection with' requirement ha[s] been met." Pet. App. 27a (quoting *Ontario Pub. Serv. Employees Union Pension Trust Fund* v. *Nortel Networks Corp.*, 369 F.3d 27, 34 (2d Cir. 2004) (internal quotation marks omitted), cert. denied, 125 S. Ct. 919 (2005)). But the court of appeals then veered off course by concluding that "[b]ecause *only* purchasers and sellers have a federal private damages remedy, it is * * * natural to suppose that Congress meant to import the settled standing rule *along with* the 'in connection with' phrase as a substantive standard" in delimiting SLUSA's preemptive scope. *Id.* at 28a (emphasis added). Nothing in the text or history of SLUSA justifies creation of such a limitation on the scope of SLUSA preemption.[3]

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[3] The two other courts of appeals that held claims by non-purchasers and non-sellers not to be preempted under SLUSA erroneously reasoned that *Blue Chip* interpreted Rule 10b-5's "in connection with"

a. The court of appeals did not (and could not) identify anything in SLUSA's text that "import[s]" the standing rule "along with" the separate "in connection with" requirement. Pet. App. 28a. Congress easily could have limited preemption to cases involving allegations of fraud "in connection with the purchase or sale of covered securities *by the plaintiff*." It did not do so. Likewise, Congress could have limited its focus to the claims of purchasers or sellers, rather than "any private party," 15 U.S.C. 78bb(f)(1)(A). Again, it did not do so. Instead, Congress intentionally employed broad statutory language that ties the preemptive force of SLUSA directly to the full scope of the prohibitions contained in Section 10(b) and Rule 10b-5 themselves. As already explained, no standing requirement limits the scope of those prohibitions. See *supra* pp. 15-17.

Congress also tailored the scope of SLUSA preemption by crafting several express exceptions to preemption, none of which applies here. See 15 U.S.C. 78bb(f)(3) and (5)(C). Those exceptions relate to derivative actions; actions based on some contractual rights; actions brought by States, political subdivisions of States, and state pension plans; and certain actions arising under the law of the issuer's state of incorporation. *Ibid.* Congress's express inclusion of those exceptions further confirms that it did not intend any others. See, *e.g.*, *TRW Inc.* v. *Andrews*, 534 U.S. 19, 28 (2001) ("Where Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are

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requirement. See *Riley*, 292 F.3d at 1343-1345; *Green*, 279 F.3d at 597-598. The Second Circuit is the only court of appeals to reach the incongruous conclusion that *Blue Chip* does *not* interpret that language but nonetheless *does* limit the scope of SLUSA preemption.

not to be implied, in the absence of evidence of a contrary legislative intent.").

The court of appeals was not "moved by the observation that the standing rule is merely a judge-made gloss on the statute and the Rule, because private Rule 10b-5 damages actions are themselves a creature of judicial implication." Pet. App. 28a. But the relevant factor of the *Blue Chip* rule is not that it was judge-made, but that it is a rule about the scope of standing as opposed to an interpretation of the substantive scope of the prohibitions in Rule 10b-5. Moreover, there is no need to infer anything about SLUSA's explicit text. Congress focused on the preemption issue and could have linked the scope of preemption to the scope of standing, but instead chose to key the scope of preemption to the conduct alleged.

The court of appeals sought support from a footnote in *Blue Chip* stating that the "disadvantage" of the purchaser/seller rule—*i.e.*, its tendency to prevent some victims of Rule 10b-5 violations from recovering damages—is "attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." 421 U.S. at 738 n.9; see Pet. App. 29a. According to the court of appeals, "SLUSA's wholesale importation of the language that gave rise to this balancing judgment must * * * be presumed to represent a ratification of that judgment." *Id.* at 30a.

This Court's passing observation in the cited footnote, which merely reflects the pre-SLUSA reality that state-law claims were not preempted, cannot sustain the weight placed on it by the court of appeals. The *Blue Chip* Court made no "balancing judgment" that standing should be denied under federal law only because and only to the extent that it was available under state law—much less that standing should be denied because

it was available in state-law *class actions*, which are the only actions preempted by SLUSA. To the contrary, this Court emphasized at length the danger of permitting suits by non-purchasers and non-sellers to proceed *at all*. See 421 U.S. at 742-748. Far from conditioning application of the purchaser/seller rule on the availability of state remedies, the *Blue Chip* Court adopted that standing limitation as a uniform requirement applicable to all private plaintiffs under Section 10(b) and Rule 10b-5, without regard to their state-law remedies. 421 U.S. at 749, 755.

Even if this Court had based the *Blue Chip* standing rule on the assumption that non-purchasers and non-sellers could assert securities fraud claims in some States, moreover, Congress could not have "ratified" that judgment by preempting all class actions based on Section 10(b)'s "in connection with" requirement. The ratification doctrine applies only to congressional reenactment of statutory texts with settled interpretations. See generally *Department of Transp.* v. *Public Citizen*, 541 U.S. 752, 770 n.4 (2004). *Blue Chip* does not interpret the "in connection with" requirement, however, and SLUSA does not address standing. Thus, the purported "balancing judgment" would not have been an interpretation of the statutory text at issue here, and the ratification doctrine provides no support for the court of appeals' reasoning. *Ibid.*[4]

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[4] The extent to which suits by "holder" classes would be actionable under state law but for the preemptive effect of SLUSA is unclear. States vary in their receptiveness to holder claims. See *In re Worldcom, Inc. Sec. Litig.*, 336 F. Supp. 2d 310, 319-323 (S.D.N.Y. 2004) (surveying state laws); Pet. App. 38a n.14. In those States that permit holder actions, moreover, SLUSA permits individual and derivative actions to proceed, and persons injured by holding stock may also bene-

b. Lacking a textual basis for its conclusion, the court of appeals turned to an "assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." Pet. App. 30a-31a (quoting *City of Milwaukee* v. *Illinois*, 451 U.S. 304, 316 (1981)). But that "'assumption' of nonpre-emption is not triggered when the State regulates in an area where there has been a history of significant federal presence." *United States* v. *Locke*, 529 U.S. 89, 108 (2000). The federal government has extensively regulated the national securities markets and securities transactions for many decades, and Congress determined that the interstate (and increasingly international) character of those markets confirms the propriety of and need for uniform national regulation of securities fraud class actions. See S. Rep. No. 182, 105th Cong., 2d Sess. 3-5 (1998). The "assumption" of non-preemption is therefore inapplicable here. Indeed, Congress enacted SLUSA for the very purpose of preempting state-law class action claims.

Even if such an "assumption" were applicable in this case, "[t]he purpose of Congress [remains] the ultimate touchstone" and "primarily is discerned from the language of the pre-emption statute and the statutory framework surrounding it." *Medtronic, Inc.* v. *Lohr*, 518 U.S. 470, 485-486 (1996) (internal quotation marks omitted). Thus, the "assumption" is overcome when, as here, the statutory text is clear. See *ibid.*; *Cipollone* v. *Liggett Group, Inc.*, 505 U.S. 504, 522-523 (1992) (plurality opinion); *id.* at 548-549 (Scalia, J., concurring in part and dissenting in part); *Shaw* v. *Delta Air Lines, Inc.*, 463 U.S. 85, 97 (1983).

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fit from state and federal enforcement actions. See pp. 3-4, 19, *supra*.

The court of appeals thought that "[t]here is no clear support in the legislative history for the conclusion that Congress intended SLUSA to preempt claims that do not satisfy the *Blue Chip* rule" because the legislative history "contains no specific mention of holding claims or other non-purchaser/non-seller claims." Pet. App. 31a. Even if the court of appeals' analysis of the legislative history were correct (but see pp. 23-26, *infra*), the *absence* of relevant legislative history would reveal nothing about Congress's intent and could not overcome the plain statutory text, which is keyed to the conduct alleged, not the plaintiff's status. *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 385 n.2 (1992); *Shaw*, 463 U.S. at 97. "[I]t would be a strange canon of statutory construction that would require Congress to state in committee reports or elsewhere in its deliberations that which is obvious on the face of a statute." *Harrison* v. *PPG Indus., Inc.*, 446 U.S. 578, 592 (1980); see *Patenaude* v. *Equitable Life Assurance Soc'y*, 290 F.3d 1020, 1025 (9th Cir. 2002) (holding that SLUSA's definition of "covered security" encompasses variable annuities even though they are not mentioned in the legislative history).

3. ***The legislative history and the policies underlying SLUSA confirm that Congress did not exempt from preemption the claims of plaintiffs who would lack standing to pursue a Rule 10b-5 claim***

The court of appeals also erred in concluding that "to the extent the legislative history casts any light on the question, it suggests that Congress intended to preempt only those state claims that had migrated from federal court in response to the PSLRA." Pet. App. 32a. Because people who neither purchased nor sold securities

lacked standing to pursue Rule 10b-5 actions before Congress enacted the PSLRA, the court concluded that Congress did not intend to affect their state-law class action claims. See *ibid.* That result, however, would turn congressional intent on its head by exempting an especially abusive category of securities fraud class actions from the uniform national standards that Congress adopted to *prevent* abuse.

a. The court of appeals was correct insofar as it recognized that Congress was concerned that plaintiffs were evading the PSLRA by bringing securities fraud class actions in state instead of federal courts. See SLUSA § 2(2) and (3), 112 Stat. 3227; H.R. Conf. Rep. No. 803, 105th Cong., 2d Sess. 1 (1998); S. Rep. No. 182, *supra*, at 3-4. But Congress responded to that development not only by permitting the removal of affected cases from state to federal courts, see 15 U.S.C. 78bb(f)(2), but "[a]dditionally" by "establish[ing] uniform national rules for securities class action litigation involving our national capital markets." H.R. Conf. Rep. No. 803, *supra*, at 13. Concerned about the "dangers of maintaining differing federal and state standards of liability for nationally-traded securities," Congress chose to give "due consideration to the benefits flowing to investors from a uniform national approach." S. Rep. No. 182, *supra*, at 3. Congress recognized that "[s]ome critics of establishing a uniform standard of liability have attacked such legislation as being an affront on Federalism," but it "found the interest in promoting efficient national markets to be the more convincing and compelling consideration in this context." *Id.* at 4.

Thus, there is no support for the improbable conclusion that Congress intended to preempt only those state-law claims that can be pursued successfully under fed-

eral law, while leaving intact all state-law claims that are legally meritless under federal law. Rather, Congress intended to apply uniform federal standards to securities class actions, which it perceived to be the source of most abusive securities litigation, "while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits." SLUSA § 2(5), 112 Stat. 3227. Congress thus drew the line between class actions and other types of securities litigation, a line that has nothing to do with whether a class action plaintiff would have standing to pursue a claim under federal law.

The court of appeals relied on a floor statement by Senator Dodd to the effect that SLUSA would work "in a very targeted and narrow way, *essentially* preempting only those class actions that have recently migrated to State court, while leaving traditional State court actions and procedures solidly in place." Pet. App. 32a-33a (quoting 143 Cong. Rec. 21,357 (1997)) (emphasis added). That floor statement of a single legislator provides no support for the court's conclusion because Senator Dodd expressly identified the "traditional State court actions and procedures" he had in mind, and actions by "holders" were not among them. *Ibid.* See also *Consumer Prod. Safety Comm'n* v. *GTE Sylvania, Inc.*, 447 U.S. 102, 118 (1980) ("[O]rdinarily even the contemporaneous remarks of a single legislator who sponsors a bill are not controlling in analyzing legislative history."). Moreover, it is not clear that Senator Dodd used the term "migrate" narrowly to exclude claims like respondent's that presumably would have been brought in federal court on behalf of purchasers before the PSLRA, migrated to state court to avoid the PSLRA, and were

later partially transmogrified into a "holder" suit to circumvent both the PSLRA and SLUSA.

More illuminating is the Senate Committee report, which explains that SLUSA is to be "interpreted broadly" to effectuate Congress's intent to "effectively reach[] those actions that could be used to circumvent" the PSLRA. S. Rep. No. 182, *supra*, at 8. Because state-law "holder" actions would circumvent the uniform federal standards of Rule 10b-5 and the PSLRA, exempting such suits from preemption would be contrary to that intent. See generally *Rowinski*, 398 F.3d at 299 ("Congress envisioned a broad interpretation of SLUSA to ensure the uniform application of federal fraud standards."); *Newby* v. *Enron Corp.*, 338 F.3d 467, 472 (5th Cir. 2003) ("[I]n enacting SLUSA Congress sought to curb all efforts to circumvent the reforms put into place by PLSRA."); *Miller*, 391 F.3d at 702 (same).[5]

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[5] The court of appeals also pointed to Senator Dodd's statement that SLUSA affects only "those types of class actions that are appropriately heard on the Federal level." 143 Cong. Rec. at 21,357; see Pet. App. 33a. As the committee reports explain, Congress concluded that class action claims regarding nationally traded securities are appropriately heard on the federal level because of the need for uniform national standards. See p. 24, *supra*. That such claims may be dismissed for lack of standing when they pose a particularly high risk of abuse does not mean that they should be heard on the state level; it means that they uniformly should be dismissed by federal courts.

Standing is far from the only reason that a claim might fail under federal but not state law. Federal securities fraud plaintiffs must satisfy heightened pleading requirements, 15 U.S.C. 78u-4(b), establish scienter in some cases, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 (1976), and prove in some cases that the alleged misrepresentations fall outside of the PSLRA's safe harbor for forward-looking statements, 15 U.S.C. 78u-5(c)(1). A plaintiff class's failure to satisfy such requirements does not mean that the class should be able to take advantage of less stringent state-law standards. Instead, it means that the suit is

b. Recognition of an implicit exception to SLUSA's preemptive scope would be particularly inappropriate in the context of this case, because an exception for claims brought by those who neither purchased nor sold securities would directly frustrate Congress's goals in enacting the statute.

i. The need for uniform national standards, like the text of SLUSA's preemption provision, does not turn on the identity of the plaintiff in a particular case. In order to "encourage the voluntary disclosure of information by corporate issuers," the PSLRA created a "safe harbor" for forward-looking statements. S. Rep. No. 98, 104th Cong., 2d Sess. 4-5 (1995); see 15 U.S.C. 78u-5. That safe harbor could not accomplish its purpose of encouraging disclosure if some plaintiffs could evade it by filing under state law. Similarly, "to encourage plaintiffs' lawyers to pursue valid claims for securities fraud and to encourage defendants to fight abusive claims," the PSLRA adopted a modified proportionate liability standard, heightened pleading requirements, and a stay of discovery pending the resolution of motions to dismiss. S. Rep. No. 98, *supra*, at 6-7 (emphasis omitted); see 15 U.S.C. 78u-4(b), (c) and (f). Those and other requirements would likewise fail to discourage the filing of meritless suits if such suits could be brought under state law on behalf of people who did not purchase or sell securities.

The artificiality of any distinction based on an individual plaintiff's trading activity (or lack thereof) is fur-

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precisely the type of class action that Congress targeted. As Judge Easterbrook explained, SLUSA's "pre-emptive effect is not confined to knocking out state-law claims by investors who have *winning* federal claims * * * It covers both good and bad securities claims—*especially* bad ones." *Kircher*, 403 F.3d at 484.

ther underscored by the fact that a single securities fraud scheme will frequently victimize purchasers, sellers, *and* holders—and there will often be substantial overlap among those classes, because purchasers generally become holders, and sellers tend to be former holders. Thus, in related proceedings before the district court that dismissed this case, purchasers and sellers are pursuing actions against petitioner based on the same underlying transactions. Pet. App. 55a. The original and amended complaints in this case likewise allege a class of purchasers and sellers, as well as holders. *Id.* at 4a-5a, 40a-41a; cf. *id.* at 42a-43a (recognizing the "close relationship" between claims based on purchases and those based on holdings as well as the difficulty in disentangling the two).

To apply uniform national standards in cases brought by purchasers and sellers, but differing state-law standards in cases brought by holders *based on the same underlying conduct*, would deprive the uniform national standards of any semblance of uniformity. In cases in which some of the misrepresentations occurred before a plaintiff's purchase of a security, it would also elevate artful pleading over substance, because such plaintiffs might attempt to avoid preemption by focusing on misrepresentations made between their purchases and sales and limiting the scope of requested damages. Respondent has done just that: after the district court dismissed respondent's original complaint because it alleged that he purchased securities in reliance on a fraudulent scheme, respondent recast himself as a "holder" in his amended complaint in hopes of avoiding preemption. See pp. 4-5, *supra*. As explained above, SLUSA was intended in part to *combat* artful pleading, not to encourage it. See pp. 12-13, *supra*. That is another reason

why a plaintiff should not be able to "avoid preemption by asserting it is only claiming damages suffered as a result of holding its stock." *Professional Mgmt. Assocs., Inc. Employees' Profit Sharing Plan* v. *KPMG*, 335 F.3d 800, 803 (8th Cir. 2003), cert. denied, 540 U.S. 1162 (2004).

ii. If any set of plaintiffs were to be exempted from preemption, it would not be those who neither purchased nor sold securities. As the court of appeals appeared to recognize, such an exemption would "*allow* the very category of claims that the Supreme Court identified in *Blue Chip* as posing a particularly high risk of vexatious litigation." Pet. App. 29a. Although private securities class actions are an important supplement to government enforcement actions, this Court recognized in *Blue Chip* that "[t]he risk of strike suits is particularly high" in cases not brought by purchasers or sellers because such plaintiffs could reach trial merely by asserting that they relied on a public misrepresentation or material omission in *not* buying or selling stock. 421 U.S. at 742.

The potential for abuse is further underscored by respondent's theory of injury and damages. Although some persons who are fraudulently induced not to purchase or sell securities may be injured thereby, see *Blue Chip*, 421 U.S. at 738, 743, the amended complaint alleges that respondent was injured by petitioner's failure to disclose that it had fraudulently inflated the stock prices because respondent would have sold his shares before the prices declined had he known the truth, see J.A. 53a-54a. That is not even a cognizable injury. Absent the alleged fraud, the prices never would have become fraudulently inflated. And if petitioner had disclosed the alleged fraud, the stock prices likely would have fallen immediately to reflect that information, pre-

venting respondent from selling at the inflated levels. See *Crocker* v. *FDIC*, 826 F.2d 347, 351 (5th Cir. 1987), cert. denied, 485 U.S. 905 (1988); *Arent* v. *Distribution Scis., Inc.*, 975 F.2d 1370, 1374 (8th Cir. 1992); *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 333-334 (2d Cir. 1971) (Friendly, J.); cf. *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 246-247 (1988). In any event, respondent "could hardly be heard to claim compensation for the premium he might have extracted from some innocent victim if he had known of the fraud and the buyer did not." *Levine*, 439 F.2d at 333. Respondent had no legally-protected right to *benefit* from the alleged fraud.

Because *Blue Chip* and SLUSA constrain potentially abusive suits in compatible ways, and suits by plaintiffs who neither purchased nor sold securities in connection with alleged fraud epitomize the potential for abusive suits that this Court and Congress sought to combat, "[i]t would be more than a little strange if [this] Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law." *Kircher*, 403 F.3d at 484. Permitting SLUSA and *Blue Chip* to complement one another would be far more consistent with congressional intent than treating the judicial restriction as annulling the congressional one.

CONCLUSION

The judgment of the court of appeals should be reversed.

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No. 04-1371

In the Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the Securities Litigation Uniform Standards Act of 1998 preempts state law class action claims brought by persons who assert that they were induced by fraudulent material statements or omissions to "hold," rather than purchase or sell, securities.

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INTEREST OF THE *AMICUS CURIAE*

The Chamber of Commerce of the United States of America is the world's largest business federation, representing a membership of nearly three million businesses and organizations of every size, in every industry sector and geographical region of the country.[1] A central function of the Chamber is to represent the interests of its members in important matters before the courts, Congress, and the Executive Branch. To that end, the Chamber has filed *amicus* briefs in numerous cases addressing issues of vital concern to the Nation's business community.

The Chamber has a substantial interest in the issue presented in this case: the preemption of state-law securities class actions brought on behalf of "holders" of securities. Securities class action litigation imposes an enormous toll on the national economy, affecting virtually every public corporation in America and costing American businesses billions of dollars in settlements every year. A recent study concluded that, over a five-year period, the average public corporation faces a 10% probability of facing at least one securities class action lawsuit. Buckberg *et al.*, NERA, *Recent Trends in Securities Class Action Litigation: Are WorldCom and Enron the New Standard?* 2 (July 2005).

Congress has enacted legislation to rein in some of the worst abuses of securities class action litigation, assuring that class actions involving nationally traded securities are heard in federal court and governed by federal standards. In this case, however, the Second Circuit approved an attempt to circumvent these standards through use of state law as the

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[1] Pursuant to Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for a party and that no person or entity, other than the *amicus curiae*, its members, and its counsel made a monetary contribution to its preparation and submission. The written consents of the parties to the filing of this brief have been filed with the clerk.

foundation for a particularly abusive and speculative form of litigation. The Chamber believes that the experience of its members makes it well situated to address the harm that will follow from the Second Circuit's approach.

INTRODUCTION AND SUMMARY OF ARGUMENT

1. It has long been settled that private litigants may not bring actions seeking damages for fraud under the Securities and Exchange Commission's Rule 10b–5, 17 C.F.R. § 240.10b–5, unless they were purchasers or sellers of securities. The question in this case is whether a person who was *not* a purchaser or seller, but instead claims that he was induced by fraud to "hold on" to his shares, may bring a national class action based upon state law. As petitioner demonstrates in some detail in its brief, the plain language of the Securities Litigation Uniform Standards Act of 1998 (the "SLUSA"), Pub. L. No. 105–353, 112 Stat. 3227 (codified as amended in various sections of 15 U.S.C.), says that the answer to that question is no.

The unequivocal language of the SLUSA preempts virtually all class actions based upon state law that allege fraud relating to nationally traded securities. The statute does not say, as the Second Circuit believed, that only suits involving purchasers and sellers are preempted. Instead, it broadly provides that *no* class action may be brought under state law by *any* private party alleging fraud *in connection* with the purchase or sale of a covered security. The alleged fraud here surely was one "in connection" with such a purchase or sale under the broad reading of the term that repeatedly has been propounded by this Court: the whole point of the assertedly fraudulent statements challenged by respondents was to influence trading in the affected securities. Respondents' claim therefore cannot be squared with the unambiguous language of the SLUSA.

2. The straightforward terms of the statute accordingly are enough to dispose of this case. But to the extent that

there is any doubt on that score, the statutory background and policy confirms that the SLUSA was meant to preempt state-law "holder" class actions. The SLUSA was the culmination of a more extensive congressional effort to combat abusive practices that infected the process of securities fraud litigation. Congress determined that meritless securities suits often succeeded in coercing settlements – a process that did investors little good, but that imposed enormous costs on issuers, shareholders, and the national economy. Congress responded by enacting the Private Securities Litigation Reform Act of 1995 ("the PSLRA"), Pub. L. No. 104–67, 109 Stat. 737 (codified as amended at 15 U.S.C. § 77a *et seq.*), which broadly reformed the process of federal securities litigation by curbing the practices that were most likely to produce extortionate settlements. When plaintiffs attempted to circumvent the PSLRA by bringing national class actions in state court under state law, Congress enacted the SLUSA's preemption provisions.

Read against this background, the Second Circuit's holding plainly will frustrate the unambiguous intent of the SLUSA. The state-law holder claims that were validated by the decision below present the very dangers of abuse that led to enactment of the PSLRA, and that Congress sought to nail into their coffins with the SLUSA. Indeed, such suits are *especially* susceptible to misuse as a vehicle to extract extortionate settlements because they allege speculative injuries that typically are proven through use of oral testimony. Congress could not have intended to allow national class actions asserting such claims to survive the SLUSA.

ARGUMENT

I. THE PLAIN LANGUAGE OF THE SLUSA PREEMPTS "HOLDER" CLASS ACTIONS BASED UPON STATE LAW

Petitioner shows in some detail how the Second Circuit's decision is inconsistent with the plain language of the

SLUSA. Rather that repeat that argument, the bulk of this brief will make a related point: the background and policy of the SLUSA show that Congress meant the broad words of the statute to be interpreted broadly. The SLUSA was intended to prevent plaintiffs from circumventing the goals of the PSLRA, which reformed the process of securities litigation in an effort to combat serious and well-documented abuses that were injuring investors, issuers, and the national economy as a whole. The Second Circuit's decision in this case, which disregards the manifest congressional intent by allowing an important category of such abusive claims to proceed, will frustrate that goal.

Before addressing the congressional policy, however, it is worth pausing to emphasize that the plain language of the SLUSA *does* resolve this case. That language is clear and unequivocal, providing that

> [n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1); 15 U.S.C. § 77p(b). The statute does *not* say, as the Second Circuit would have it, that only suits by purchasers or sellers are preempted; instead, it declares that *no* covered class action based on state law of any kind may be maintained in *any* court by *any* private party alleging fraud *in connection with* the purchase or sale of a security.[2]

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[2] The breadth of the statutory language is suggested by SLUSA's definition of preempted "covered class action," which is broader than that of Rule 23 of the Federal Rules of Civil Procedure. See 15 U.S.C. § 77p(f)(2); S. Rep. No. 105–182, at 8 (1998) ("[I]t re-

There is no doubt that the SLUSA's "in connection with" language, which was borrowed from Section 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b), is broad enough to reach the conduct alleged in this case. It has long been recognized that, as the Second Circuit itself put it in its seminal decision in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (en banc), the "in connection with" requirement is satisfied when a misrepresentation is made "in a manner reasonably calculated to influence the investing public." And this Court has since repeatedly confirmed that, under the "in connection with" language, "[i]t is enough that the scheme to defraud and the sale of securities coincide." *SEC* v. *Zandford*, 535 U.S. 813, 822 (2002). See, *e.g.*, *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 12–13 (1971) ("in connection with" includes deceptive practices "touching" the sale of securities); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 476 (1977) (same). Here, it can hardly be denied that the conduct alleged by plaintiffs – dissemination of false analyst reports to the trading public – satisfies this standard.

Nor is there room to impose extra-statutory limits on the scope of the SLUSA's language. The statute contains three express, narrowly defined exceptions from preemption (see 15 U.S.C. § 78bb(f)(3)); suits by holders of securities, which are of an entirely different character from those exceptions, are not one of them. And the Second Circuit plainly erred in its belief that, because only purchasers and sellers of securities have standing to bring private actions under the SEC's Rule 10b–5, 17 C.F.R. § 240.10b–5, the SLUSA likewise preempts only class actions brought by purchasers and sellers. The purchaser/seller limitation is based on the policy of the Rule 10b–5 implied right of action and "does not stem

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mains the Committee[']s intent that the bill be interpreted broadly to reach mass actions and all other procedural devices that might be used to circumvent the class action definition.")

from a construction of the phrase 'in connection with the purchase or sale of any security.'" *Holmes* v. *Sec. Investor Prot. Corp.*, 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and concurring in the judgment). See *United States* v. *O'Hagan*, 521 U.S. 642, 651 (1998) (Section 10(b) "does not confine its coverage to deception of a purchaser or seller of securities"). That is why the purchaser/seller limitation does not affect the SEC's enforcement authority or the United States' prosecutorial authority under Section 10(b). See, *e.g.*, *Zandford*, *supra*; *United States* v. *Naftalin*, 441 U.S. 768, 774 n.6 (1979); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 751 n.14 (1975).

The SLUSA's language thus is dispositive. The respondents' suit here is a "covered class action." It is based upon the "statutory or common law" of a state. It claims a "misrepresentation or omission of a material fact." And – because those alleged misstatements plainly coincided with (and supposedly were intended to induce) trading in securities – the misstatements were made "in connection with" the purchase or sale of securities. That is enough to dispose of this case.

II. THE POLICY AND UNAMBIGUOUS CONGRESSIONAL INTENT UNDERLYING THE SLUSA PREEMPTS "HOLDER" CLASS ACTIONS BASED UPON STATE LAW

Respondents' claim accordingly should not survive application of the statutory language. But to the extent that there is any doubt on that score, the statutory background and policy confirm that the SLUSA was meant to preempt state-law holder class actions. The SLUSA was intended to effectuate the congressional intent to prevent certain abusive practices that had bedeviled securities litigation prior to enactment of the PSLRA. And state-law holder suits, of the type at issue here, present precisely the dangers of abuse that Congress had in mind.

A. The Pressure To Settle Even Meritless Securities Class Actions Imposes An Enormous Toll On The National Economy

In determining Congress's goal in enacting the SLUSA, it is helpful to begin with the problems that prompted enactment of legislation reforming securities litigation. As this Court has long recognized, securities fraud litigation presents "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. Such lawsuits contain unique elements that encourage defendants to settle even insubstantial claims – and that, as a consequence, encourage plaintiffs to file them. This phenomenon is a function of the incentives faced by both issuers and plaintiffs. See generally Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986). These incentives, in turn, stem from asymmetries in the risks and rewards of litigation.

1. The direct costs of litigation – especially the process of discovery – impose enormous burdens on defendants. See, *e.g.*, Kassis, *The Private Securities Litigation Reform Act of 1995: A Review of Its Key Provisions and an Assessment of Its Effects at the Close of 2001*, 26 SETON HALL LEGIS. J. 119, 124 (2001) (describing the discovery process as "financial blood letting"). Moreover, the lost productivity and business disruption caused by the discovery process may "dwarf the expense of attorneys' fees." Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 953 (1999); see also *Blue Chip Stamps*, 421 U.S. at 742–743 (describing "the threat of extensive discovery and disruption of normal business activities" posed by securities class actions); S. Rep. No. 104–98, at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693.

Wholly aside from the costs of litigation, the sheer size of the damages demanded in national class actions makes it attractive for defendants to forgo the adversarial process and settle even meritless suits to avoid the prospect of ruinous liability. The arithmetic is implacable: a 10% chance of facing a $300 million judgment makes a settlement of $29.9 million look attractive. Joint and several liability presents the same quandary to peripheral actors, such as underwriters and accountants, who might be named defendants because of their deep pockets and thus be exposed to liability for a grossly disproportionate share of the damages. See H.R. Conf. Rep. No. 104–369, at 37–38 (1995); S. Rep. No. 104–98, at 5, 9.

This is so regardless of the strength of the plaintiffs' claims. An influential study found that the costs and risks of litigation made the merits of securities suits largely irrelevant to the decision to settle. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 516–517 (1991).[3] Instead, the best predictors of whether suit would be brought and the size of the ultimate settlement were declines in stock price and the amount of the defendant's insurance coverage. *Id.* at 550.[4] The hearings

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[3] See also Garry *et al.*, *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D. L. REV. 275, 287 n.98 (2005) (citing additional studies); Bohn & Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 979–980 (1996) (evaluating proxies for merit of pre-PSLRA securities fraud class actions arising out of IPOs, such as underwriter quality and insider sales, and concluding that "most securities-fraud class actions are, in fact, frivolous"); Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 742–743 (1995) (reviewing a sample of settlements in which 23 percent of the settlements were for less than $2 million, suggesting that the suits held only a nuisance value).

[4] See also Thompson & Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859,

that preceded the enactment of the PSLRA were replete with testimony and studies supporting the proposition that securities suits commonly followed a drop of 10 percent or more in a security's price and that most suits were settled within the boundaries of the applicable insurance policy.[5]

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894 (2003) (reporting that most complaints filed in 1999 were based on stock market drop); Martin *et al.*, *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J. L. BUS. & FIN. 121, 153, 157 (1999); Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 949–50 (1993) (reporting that in one industry, a class action was filed to challenge *every* IPO where the stock traded below the IPO price after 15 months). The rise in securities class action suits against high-technology firms after the bursting of the stock market bubble in 2001 mirrors a similar spike in suits following a downturn in the Hambrecht and Quist High Technology Index in 1983. See Garry *et al.*, *supra*, 49 S.D. L. REV. at 290.

[5] See, *e.g.*, *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., & Urban Affairs* ("*1993 Senate Hearings*"), 103d Cong., 1st Sess. 10, 12 (1993) (statement of Edward R. McCraken, President and CEO of Silicon Graphics, Inc.) (testifying that a lawsuit was filed several weeks after Silicon Graphics, Inc.'s 10 percent drop in stock price that resulted from the company's lower than expected earnings); see also *Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of. the S. Comm. on Banking, Hous., and Urban Affairs*, 103d Cong., 2d Sess. 190 n.37 (1994) (discussing technology industry representatives' reports that strike suits would be filed whenever stock price decreased 10% or more). Numerous SEC Chairmen and Commissioners echoed these concerns and have urged reform of securities class actions. See *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs* ("*Reform Act Senate Hearings*"), 104th Cong., 1st Sess. 229 (1995) (then-Chairman Arthur Levitt); *id.* at 239 (former Acting Chairman Charles C. Cox); *id.* at 49–50 (former Commissioner J.

2. These insubstantial strike suits are of little benefit to shareholders – even to shareholder plaintiffs. Every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold after disclosure of the truth). See Posner, ECONOMIC ANALYSIS OF THE LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from "a legal rule that forces his winning self to compensate his losing self over and over." Easterbrook & Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 340 (1991); see also Thakor, *et al.*, U.S. Chamber Institute for Legal Reform, *The Economic Reality of Securities Class Action Litigation* 1 (2005), available at http://www.instituteforlegalreform.com/pdfs/EconomicRealityNavigant.-pdf (explaining that diversified institutional investors in particular are for this reason overcompensated as a result of litigation). Even worse, such wealth transfers entail significant transaction costs. To the extent that class members still own shares in the issuer, "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up." Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996); see also Coffee, *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse* Broudo, 60 BUS. LAW. 533, 542–543 (2005); Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 921–922; Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 638–639 (1985).

Carter Bresse, Jr.); S. Rep. 104–98, at 21 (noting testimony of former Chairman David S. Ruder); *id.* at 16 (noting testimony of former Chairman Richard C. Breeden); Shad, *Introduction to Securities Class Actions: Abuses and Remedies* 1 (1996); Grundfest, *supra.*

More profoundly, the costs of abusive litigation are felt throughout the national economy. These costs are borne disproportionately by the most innovative and entrepreneurial companies, which are targeted because the volatility in their share price attracts the attention of the plaintiffs' bar.[6] And abusive securities class action litigation has enormously destructive ripple effects. The risk of out-of-control liability deters competent individuals from serving as independent directors on corporate boards. S. Rep. No. 104–98, at 21. Accounting firms, often named as deep-pocket defendants, become less willing to perform auditing services (*id.* at 21–22) – especially for "newer and smaller companies" that are for that reason less likely to be able to obtain high-quality professional services, as "business failure would generate securities litigation against the professional, among others." *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994), *abrogated by* 15 U.S.C. § 78t; H.R. Rep. No. 104–50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets," and "businesses suffer as auditors and directors decline engagements and board positions"); Alexander, *supra*, 43 STAN. L. REV. at 570–573. D&O insurers must increase premiums or stop underwriting policies altogether. S. Rep. No. 104–98, at 21.

Furthermore, because any statement that later is proven inaccurate or any prediction that fails to come true could form the predicate for an allegation of fraud, the prospect of liability chills corporate disclosures of information that could be useful to investors, thus directly frustrating the disclosure objectives of the federal securities laws. See *id.* at 15–16; Easterbrook & Fischel, *supra*, at 339 (noting that because a

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[6] See *Reform Act Senate Hearings*, *supra*, at 109 (testimony of George Sollman on behalf of the American Electronics Association) (estimating that about half of the top 100 companies in Silicon Valley have been subjected to a securities class action lawsuit at least once).

firm that discloses information "inevitably takes the risk of excessive optimism and excessive pessimism," a "rule penalizing excesses in either direction would lead to silence" about a company's prospects). The risk of liability also muzzles corporate managers' communications with analysts, which are "necessary to the preservation of a healthy market." *Dirks* v. *SEC*, 463 U.S. 646, 658–659 (1983); see also SEC, Release No. 33–7881, 65 Fed. Reg. 51716, 51718 n.19 (2000) ("fear of legal liability" "chill[s]" communications with analysts). When SEC disclosure requirements do not make silence an option, issuers may respond to the threat of unconstrained liability with defensive disclosures that "bury the shareholders in an avalanche of trivial information." *TSC Indus.* v. *Northway, Inc.*, 426 U.S. 438, 448–449 (1976).

In addition to detracting from the quantity and quality of information received by investors, securities class action abuse reduces the overall competitiveness of United States securities markets, as fear of potential liability deters foreign companies from listing on domestic stock exchanges. *Common Sense Legal Reform Act: Hearings on H.R. 10 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce*, 104th Cong., 1st Sess. 221, 224 (1995) (statement of former SEC Chairman Richard C. Breeden) ("Based on conversations with potential issuers of securities all over the world, the fear of litigation inhibits foreign firms from participating in the U.S. market[s]."); see also PricewaterhouseCoopers LLP, *2004 Securities Litigation Study* 2 (Mar. 2005), available at http://www.10b5.com/2004_study.pdf (reporting that a record 29 foreign issuers were sued in domestic securities class actions in the 2004 fiscal year).

Ultimately, the decline in the efficiency and competitiveness of domestic capital markets and the concomitant increase in the expense of corporate governance mechanisms are absorbed by shareholders in the form of reduced earnings or passed along to the general public in the form of higher

prices. Abusive securities class actions thus amount to a litigation tax on capital formation and consumption that impedes job creation, injures investors, and weakens the Nation's economy.

B. The PSLRA Adjusted Litigation Incentives And Reoriented Securities Class Action Litigation To Deter Fraud And Compensate Investors Who Truly Were Injured

1. In the face of these abuses, Congress acted to broadly reform the process of securities litigation. This movement began with enactment of the PSLRA in 1995. That statute took far-ranging steps to rein in meritless litigation and increase issuers' incentives to disclose information to investors:

- To ensure that investors rather than their lawyers exercise primary control over litigation and eliminate the race-to-the-courthouse mentality that discouraged pre-filing investigation of complaints, the PSLRA requires national publication of a notice advising class members of the filing of a class action and selection of a "lead plaintiff," with a presumption that the most suitable plaintiff is the class member or group that has the largest financial stake in the litigation. 15 U.S.C. §§ 77z–1(a)(3)(B), 78u–4(a)(3)(B). The presumption is intended to "encourage institutional investors to take a more active role in securities class action lawsuits." H.R. Rep. No. 104–50, at 34; see also Weiss & Beckerman, *Let the Money Do the Monitoring*, 104 YALE L.J. 2053 (1995).[7]

[7] Because, prior to the PSLRA, the first law firm to file a complaint would be anointed lead counsel and thus garner the lion's share of any contingency fee recovery, the resulting race to the courthouse discouraged plaintiffs' counsel from fully investigating claims before filing suit. Law firms maintained a stable of profes-

- The PSLRA prohibits bonus payments to class representatives (*id.* §§ 77z–1(a)(4), 78u–4(a)(4)) and limits investors to serving as a class representative no more than five times during any three-year period. *Id.* §§ 77z–1(a)(3)(B)(vi), 78u–4(a)(3)(B)(vi).

- To better align the incentives of class counsel with the class, the PSLRA limits attorneys' fees to a reasonable percentage of the damages and prejudgment interest actually paid to the class. *Id.* §§ 77z–1(a)(6), 78u–4(a)(6).

- To reduce the "fraud by hindsight" problem (see generally Gulati, *et al.*, *Fraud by Hindsight*, 98 NW. U. L. REV. 773 (2004)), the PSLRA creates a "safe harbor" for projections of future performance that were not knowingly false. 15 U.S.C. §§ 77z–2(c)(1)–(2), 78u–5(c)(1)–(2).

- The PSLRA imposes a heightened pleading standard to prevent plaintiffs from suing first and attempting to identify actionable fraud only after expensive fishing-expedition discovery. Plaintiffs

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sional plaintiffs – the "world's unluckiest investors" (H.R. Conf. Rep. No. 104–369, at 32 (1995)) – who would receive bonuses for lending their names to class action complaints that were filed within days or hours of any dramatic decline in share price. See *Reform Act Senate Hearings*, *supra*, at 118 (statement of Sen. Peter Domenici) (more than 20% of securities class actions filed within 48 hours of negative news); *1993 Senate Hearings*, *supra*, at 7–8 & Ex. 1 (letter from Melvyn I. Weiss to Sen. Donald W. Riegle) (reporting that over three-year period, out of 229 Rule 10b–5 actions filed by his firm, 157 filed within 10 days of major adverse disclosure by defendant). Predictably, many of the complaints were verbatim copies of those previously filed. See, *e.g.*, *In re Philip Morris Sec. Litig.*, 872 F. Supp. 97, 98 (S.D.N.Y. 1995), aff'd in part and rev'd in part, 75 F.3d 801 (2d Cir. 1996).

must identify each allegedly fraudulent statement and explain why it is fraudulent, and must state with particularity facts giving rise to a "strong inference" that the defendant acted with "the required state of mind." *Id.* § 78u–4(b)(2).

- The PSLRA mandates imposition of sanctions for violations of Rule 11 of the Federal Rules of Civil Procedure, with the presumptive award being the amount of defendants' attorneys' fees and costs for defending the suit. *Id.* §§ 77z–1(c), 78u–4(c).

- The PSLRA imposes a stay of discovery during the pendency of a motion to dismiss, unless the court finds that discovery is necessary to preserve evidence or prevent undue prejudice. *Id.* §§ 77z–1(b), 78u–4(b)(3). In combination with the heightened pleading standards, the discovery stay is intended to ensure that nonmeritorious complaints do not impose enormous litigation costs on defendants.

- The PSLRA codified the "loss causation" requirement; in addition to showing that fraud induced the purchase a security, plaintiffs must show that the fraud actually caused the security's price to be artificially inflated. 15 U.S.C. § 78u–4(b)(4); see also *id.* § 77*l*(b). Otherwise, private securities actions "would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission." *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S. 375 (1983). See *Dura Pharms., Inc.* v. *Broudo*, 125 S. Ct. 1627 (2005).

- To help prevent the prospect of massive damage awards coercing otherwise unjustified settlements,

the PSLRA replaced joint and several liability for peripheral defendants with proportionate liability if those defendants did not knowingly violate the securities laws. *Id.* §§ 77z–2(c)(2), 78u–4(g)(3), 78u–5(c)(2). To preclude a treble damage award under the Racketeering Influenced and Corrupt Organization Act of 1970, securities fraud was eliminated as a predicate for a civil racketeering claim, and mail and wire fraud may not constitute a predicate RICO offense if the underlying conduct would be actionable as securities fraud. 18 U.S.C. § 1964(c). And to increase the accuracy of damage awards, the PSLRA provided that damages must be measured by the difference between the price the plaintiff paid for the security and the mean trading price of the security during the ninety-day period after dissemination of corrective information to the marketplace. 15 U.S.C. § 78u–4(e)(1).

- In addition to addressing the litigation incentives of plaintiffs, defendants, and lawyers, the PSLRA strengthened other enforcement mechanisms. For example, it required firms auditing public companies to take certain measures to detect fraud and to disclose any unlawful acts they uncover (15 U.S.C. § 78j–1); the statute vested the SEC with the power to prosecute those who aid and abet violations of the securities laws. *Id.* § 78t(f).

2. The PSLRA had a limited but significant success in squeezing out abusive litigation while preserving the opportunity for plaintiffs to advance meritorious securities claims under federal law, thus rationalizing the system of securities litigation. The statute certainly did not close the courthouse door to plaintiffs: with the exception of a brief decline in litigation activity the year after the enactment of the PSLRA, the mean number of securities issuers sued each year has in-

creased to 258, a 33% increase over the pre-PSLRA average. See Securities Class Action Clearinghouse ("SCAC"), at http://securities.stanford.edu/.

Moreover, the dollar magnitude of settlements has increased. Eight post-PSLRA settlements have exceeded $500 million: the Enron and WorldCom litigations, while still pending, already have produced settlements of $7.16 billion and $6.128 billion, respectively; the Cendant litigation settled for $3.525 billion; AOL Time-Warner settled for $2.5 billion; parts of the IPO Allocation Litigation against numerous issuers settled for $1 billion; McKesson HBOC settled for $960 million; Lucent Technologies settled for $673 million; and Raytheon Corporation settled for $535 million. See SCAC Top Ten List, at http://securities.stanford.edu/top_ten_list.html.

Even adjusting for inflation and excluding the WorldCom partial settlement announced in May 2004, a record $2.881 billion in settlements were reached last year. Simons & Ryan, *Post-Reform Act Securities Settlements: Updated Through December 2004* 1, available at http://securities.stanford.edu/Settlements/REVIEW_1995-2004/Settlements_Through_12_2004.pdf. The total value of settlements has exceeded the $2 billion mark for the last five years. *Ibid.* This increase reflects not only a higher number of settlements, but also an increase in the average settlement size. While over 65% of settlements in 2004 were for less than $10 million, seven exceeded $100 million and the "percentage of 'mid-range' settlements between $60 million and $100 million" increased significantly. *Id.* at 3. Although the median settlement in the pre-Reform Act era was $3.5 million, Bajaj *et al.*, *Securities Class Action Settlements*, 43 SANTA CLARA L. REV. 1001, 1022–1023 (2003), the most recent figures indicate that the median settlement value has risen steadily, and reached $6.8 million in the first half of 2005. Buckberg, *et al.*, *supra*, at 4. One study attributes part of that increase to the increasing participation of institu-

tional investors as lead plaintiffs, which now occurs in 35% of post-PSLRA cases. Simons & Ryan, *supra*, at 9.

On the other hand, the dismissal rate of federal securities class actions also has risen. The percentage of securities fraud cases that were involuntarily dismissed (including through summary judgment) roughly doubled after enactment of the PSLRA. See Buckberg, *et al.*, *supra*, at 3; Painter *et al.*, *Private Securities Litigation Reform Act: A Post-Enron Analysis* 7–9 (2002) (gathering studies analyzing data through 2001), available at http://www.fed-soc.org/pdf/PSLRAFINALII.PDF. While pretrial dismissals disposed of 20.3% of securities cases filed between 1991 and 1995, that rate has increased to 39.3% of cases filed between 1996 and 2002. Buckberg, *supra*, at 3.

These contrasting sets of figures – more dismissals, but higher settlement values for cases that are not dismissed – suggest that the PSLRA has had some success. A higher dismissal rate indicates that frivolous actions are more likely to be dismissed, with surviving cases more likely to be those involving more substantial claims. Pritchard, *Should Congress Repeal Securities Class Action Reform?* 9 (Univ. of Mich. John M. Olin Center Working Paper No. 03–003, 2003) ("If only strong claims lead to settlements, class actions are producing more cost-effective deterrence."). See Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1477–1498 (2004) (canvassing the existing literature and concluding that it provides evidence that "frivolous suits existed prior to the PSLRA and that a shift occurred in the post-PSLRA period toward more meritorious claims"). Moreover, studies confirm that indicia of possible fraud – such as restatements of accounting results and allegations of insider trading – play a larger role in the filing and settlement of securities fraud class actions after the en-

actment of the PSLRA than before. See Simons & Ryan, *supra*, at 7; Pritchard, *supra*, at 11.[8]

C. The SLUSA Was Enacted To Prevent Frustration Of The PSLRA's Reforms

Prior to the enactment of the PSLRA, state securities laws – the subject of the SLUSA – had played virtually no role in class action litigation involving securities traded on national exchanges. But that changed as plaintiffs and their attorneys attempted to circumvent the PSLRA's reforms. The plaintiffs' bar had brought "essentially no significant securities class action litigation" in state courts before the effective date of the PSLRA. H.R. Rep. No. 105–640, at 10 (1998). In the two years after the enactment of the PSLRA, however, at least 104 state-law securities class actions were filed. Rosen, *The Statutory Safe Harbor for Forward-Looking Statements After Two and a Half Years: Has It Changed the Law? Has It Achieved What Congress Intended?*, 76 WASH. U. L.Q. 645, 670 (1998). Congress heard

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[8] We note, though, that the pressure on corporations to settle regardless of the merits of the case remains high. The magnitude of the pressure to settle even the most frivolous of cases is illustrated by the fact that fewer than 1% of securities fraud class actions are ultimately taken to trial. See Painter *et al.*, *supra*, at 8. See Pritchard & Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act* 4 (Univ. of Mich. John M. Olin Center for Law & Economics, Working Paper 03–011, 2003); Black, *et al.*, *Outside Director Liability* 34 (Univ. of Mich. John M. Olin Center for Law & Economics, Working Paper No. 250, 2003) (finding only one securities case that proceeded to trial). The pressure on defendants is so great that, even when they do succeed in obtaining a dismissal with prejudice in the trial court, the risk of losing on appeal may lead to enormous settlements. For example, a securities class action defendant recently agreed to settle for $300 million even after prevailing in the trial court. See Weil, *Win Lawsuit—and Pay $300 Million*, Wall St. J., Aug. 2, 2004, at C3.

testimony that in California alone, about five times as many state securities class actions were filed in the first six months of 1996 than in the first six months of 1995, prior to the enactment of the PSLRA. H.R. Rep. No. 105–640, at 10 (1998); see also Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39–Fall TEX. J. BUS. L. 295, 309–310 & nn. 97–98 (2003).

Predictably, the weaker cases, which would not pass muster in federal court after the PSLRA, were the ones filed in state court. See Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 307–318 (1998); SEC, Office of General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, Apr. 1997, at 84 (noting that increase in filings of state securities class actions "may reflect a migration of weaker cases to state court"). Moreover, savvy plaintiffs' lawyers could magnify the coercive pressure to settle these strike suits by engaging in state-court forum shopping. See Chao, *Securities Class Actions and Due Process*, 1996 COLUM. BUS. L. REV. 547, 550–551 (describing the resulting "race to the bottom" settlement process in state courts); see also Garry *et al.*, *supra*, 49 S.D. L. REV. at 276 (2005) (noting increase in filings in Mississippi).[9]

The obvious effect of the movement of securities class actions to state court was to frustrate the PSLRA's purposes and to resurrect the abusive practices that Congress had sought to discourage. To offer just one example, the balkani-

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[9] Members of the plaintiffs' bar attempted to obtain the passage of state legislation that would have increased this substitution effect; an ultimately defeated ballot initiative in California would have transformed the state into a "Mecca" for securities class action litigation. See Walker, *Evaluating the Preemption Evidence: Have the Proponents Met Their Burden?*, 60 L. & CONTEMP. PROBS. 237, 241 (1997).

zation of securities law produced by the proliferation of state securities litigation threatened to render the safe harbor provision of the PSLRA a dead letter. See S. Rep. 105–182, at 4. The SEC warned that "[c]ompanies have been reluctant to provide significantly more forward-looking disclosures than they had prior to the enactment of the safe-harbor" (SEC, *supra*, at 3) because, in part, of "fear of state court liability, where forward looking statements may not be protected by the Federal safe harbor." *Id.* at 27. The data revealed that allegations in complaints filed in state court were more than twice as likely to be based on forward-looking statements than were complaints filed in federal court. *Id.* at 77 (25% of "stand-alone" state complaints (those filed without a parallel federal suit) "are based solely on failed forecasts (as compared to twelve percent at the federal level)").

This evidence of the migration of securities class action litigation to state court led Congress to enact the SLUSA. The statute's parallel provisions added to the Securities Act of 1933 and the Exchange Act of 1934 provide that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging," "in connection with the purchase or sale of a covered security," either "an untrue statement or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance * * *." 15 U.S.C. §§ 77p(b), 78bb(f)(1). Under the SLUSA, if such a class action is brought in state court, it may be removed to federal district court and thereafter dismissed. *Id.* §§ 77p(c), 78bb(f)(2).

There is no mystery about Congress's goal in this legislation: the SLUSA's preemption of state law was intended to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]." Pub. L. No. 105–353, § 2(5), 112 Stat. 3227, 3227 (codified at 15 U.S.C. § 78a note). Representative Bliley, the House Manager, remarked that "[t]he premise of this

legislation is simple: *lawsuits alleging violations that involve securities that are offered nationally belong in Federal court.*" 144 Cong. Rec. H10771 (daily ed. Oct. 13, 1998) (emphasis added). See also H.R. Conf. Rep. No. 105–803, at 13 (1998) ("this legislation establishes uniform national rules for securities class action litigation involving our national capital markets").

D. Excepting State-Court "Holder" Suits From SLUSA Preemption Would Frustrate The Congressional Purpose

Against this background, it is manifest that the Second Circuit's decision, which allows state-law holder suits to proceed, is inconsistent with the central purpose of the SLUSA. Congress determined that the securities litigation process was rife with abuses that were harming issuers and shareholders alike, and reacted by promulgating the corrective rules of the PSLRA. When plaintiffs' counsel sought to circumvent those rules by bringing national securities class actions under state law – a species of suit that had virtually never before been seen – Congress responded by providing broadly in the SLUSA that class actions involving nationally traded securities should proceed only under federal law. For several reasons, the decision below, which again allows plaintiffs' lawyers to avoid the PSLRA's requirements by bringing a novel type of national class action, cannot be squared with that intent.

1. To begin with, holder suits present exactly the sorts of dangers that led to enactment of the PSLRA in the first place. Indeed, this Court imposed the purchaser/seller requirement on the cause of action implied under Rule 10b–5 precisely because holder actions are *especially* susceptible to use as an abusive vehicle to extract extortionate settlements. The Court examined this point at some length in *Blue Chip Stamps*, explaining that, in contrast to purchasers and sellers, "a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury such as

the loss of a noncontractual opportunity to buy or sell, is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective analysis." 421 U.S. at 734–735.

This means that a holder action "will turn largely on which oral version of a series of occurrences the jury may decide to credit, and therefore no matter how improbable the allegations of the plaintiff, the case will be virtually impossible to dispose of other than by settlement." *Blue Chip Stamps*, 421 U.S. at 742. A holder suit also necessarily "would throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony," a circumstance where "dangers of * * * abuse appear to exist * * * to a peculiarly high degree." *Id.* at 743. And this problem would be compounded because "[t]he jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant." *Id.* at 746.

And that is not the end of the abuse made possible by holder actions. In the absence of a rule that permits only purchasers and sellers to bring private securities suits,

> bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused non-selling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow restrospectively golden opportunities to pass.

Blue Chip Stamps, 421 U.S. at 747. Holder suits thus "would appear to encourage the least appealing aspect of the use of the discovery rules" (*id.* at 741) and would "'lead to large judgments, payable in the last analysis by innocent investors,

for the benefit of speculators and lawyers.'" *Id.* at 739 (quoting *Texas Gulf Sulphur*, 401 F.2d at 867 (Friendly, J., concurring)); see also *Dura*, 125 S. Ct. at 1631–1632 (emphasizing that a decline in stock price "after the truth makes its way into the market place * * * may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price"); *Holmes*, 503 U.S. at 272–273 (precluding recovery on behalf of customers who had not themselves traded in manipulated securities but whose brokers were rendered insolvent by doing so, because "[i]f the nonpurchasing customers were allowed to sue, the district court would first need to determine the extent to which their inability to collect from the broker-dealers was the result of the alleged conspiracy to manipulate, as opposed to, say, the broker-dealers' poor business practices or their failures to anticipate developments in the financial markets.").

2. In addition, allowing holder claims to proceed would be unlikely either to deter fraud or to benefit shareholders. As a logical matter, holders of securities, viewed as a class, cannot be injured. A holder claim assumes that fraud led the class to keep a stock rather than sell it so as to take advantage of an artificially inflated stock price. But if the fraud had not occurred, the stock price would not have been inflated – especially if, as the holder claim implies, shareholders would have sold their shares had accurate information been released to the market – and so there would have been no profits from the sale. See, *e.g.*, *Arent* v. *Distribution Scis., Inc.*, 975 F.2d 1370, 1374 (8th Cir. 1992) ("Plaintiffs were not harmed because they were unable to realize the true value of their stock – they were harmed because the true value of their stock was zero."); *Crocker* v. *FDIC*, 826 F.2d 347, 351 (5th Cir. 1987) (absent fraud, "there would have been no market for the stock at the artificially high price," and "[w]ithout such a

market, the [holder's] envisioned 'profit opportunity' evaporates into hardly more than an illusion").

By the same token, "[t]he deterrent effect is weak" when "the merits of claims" are "irrelevant to their initiation or settlement values," as promises to be the case with state-law holder damages suits. Winter, *supra*, 42 DUKE L.J. at 952. And truly meritorious claims, of course, can be brought in federal court as traditional purchaser/seller suits; holder actions are premised on a drop in stock price, and the share price can change only if there are purchasers and sellers who could themselves pursue "fraud on the market" claims. See *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 245–247 (1988).

3. Viewed in this light, state-law holder suits present all of the dangers that prompted enactment of the PSLRA. Such suits, of course, will proceed outside of the PSLRA's rules: they may, for example, allow for joint and several liability and punitive damages; may premise liability on forward-looking statements; will not make use of the discovery stay and pleading standards that have curbed abusive discovery; and will not apply the lead plaintiff rules that discourage the "race to the courthouse door." There is every reason to believe that state-law holder suits will, for this reason, become the plaintiffs' vehicle of choice. See Pet. 17 n.5 (gathering 24 such cases); see also H.R. Conf. Rep. No. 105–803, at 14–15 (noting plaintiffs' attorneys' attempt to "circumvent the [PSLRA's] provisions by exploiting differences between Federal and State laws by filing frivolous and speculative lawsuits in State court, where essentially none of the Reform Act's procedural or substantive protections against abusive suits are available"). After all, virtually any purchaser or seller claim could, if gerrymandered as to the timing of the class period and tweaked a bit in its allegations, be stated as a holder suit.

As a consequence, there is little doubt that, under the Second Circuit's approach, holder suits will impose significant costs on defendants through fishing-expedition discov-

ery and interruption of business, and will pose the danger of enormous liability. Such suits accordingly will lead to substantial settlements, even when (as often will be the case) they are wholly lacking in merit. They will discourage corporate disclosures of information. They are unlikely to do investors any good. And they will impose heavy costs on all participants in the securities markets. Indeed, the only winners in this system of blackmail suits and windfall settlements will be the lawyers.

The Second Circuit's holding thus leads to a bizarre and anomalous result. For more than fifty years, the federal courts have precluded holder suits under Rule 10b–5 because such actions are so easily abused. See *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). The PSLRA and the SLUSA were designed to *tighten* the federal securities rules to further combat meritless litigation. Yet the court of appeals read the SLUSA to have excluded from the scope of the PSLRA's substantive provisions, alone among the favored weapons in the strike suit arsenal, this *most* abusive type of claim. It seems plain that Congress could not have had any such intent.

4. Finally, we note that, wholly apart from private damages litigation, significant deterrents to fraud affecting holders of securities are in place. SEC regulations impose stringent reporting obligations on corporations, subject to SEC enforcement proceedings. Corporations must file quarterly and annual financial statements, which executives now must certify under threat of criminal penalty and disgorgement of their compensation and stock trading profits. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file Form 8–K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance sheet financial obligations, and changes in officers or directors. SEC, Release No. 33–8400, 69 Fed. Reg. 15594 (2004).

The powers of the SEC and Department of Justice to enforce these corporate disclosure obligations are substantial. The Commission may obtain injunctive relief, cease-and-desist orders, orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of any gain. 15 U.S.C. §§ 78u, 78u–3. Under the Sarbanes-Oxley Act, the SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

A person who willfully and knowingly makes a false or misleading statement of material fact may also be criminally liable and is subject to imprisonment for 20 years and multi-million dollar fines. *Id.* § 78ff. The Securities Act authorizes many similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y.

The SEC does not shy away from invoking these powers. During fiscal year 2004 alone, the SEC initiated 973 investigations of possible violations of the securities laws and brought 264 injunctive actions and 375 administrative proceedings against issuers and financial services providers – far more than the 236 private securities actions filed in federal court in 2004 (see SCAC, *supra*), and greatly in excess of the number of state-law holder actions over the past several years. The Commission obtained orders requiring the disgorgement of $1.9 billion and the payment of $1.2 billion in penalties.[10] The Department of Justice's Corporate Fraud Task Force has charged over 900 defendants since it was

[10] SEC 2004 Annual Report app. C at 3, 21, available at http://www.sec.gov/about/secpar/secpar04stats.pdf. Details on recent settlements may be found on the SEC's website.

formed in July 2001, and has obtained over 500 guilty pleas and convictions.[11]

State prosecutors and blue-sky officials bring their own overlapping civil and criminal enforcement actions. Among state securities law enforcers, for example, the New York Attorney General alone has reported substantially more than a billion dollars in recent settlements with financial services companies.[12]

Financial services industry Self Regulating Organizations ("SROs") also enforce regulations that implement and supplement the securities laws. In 2004, the National Association of Securities Dealers barred 454 individuals from the securities business, suspended 379 others, and expelled 22 firms.[13] The New York Stock Exchange brought 195 cases of rules violations against members that year.[14]

Securities market participants are thus policed by an array of federal and state government powers (both civil and criminal), SRO sanctions, and, of course, civil liability under the federal securities laws in actions conducted according to

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[11] See Second Year Report to the President: Corporate Fraud Task Force 2.3 (2004), at http://www.usdoj.gov/dag/cftf/2ndyr_fraud_report.pdf.

[12] See http://www.oag.state.ny.us/press/2005/jul/jul20a_05.html ($125 million settlement in mutual fund market timing case); *id.* at feb/Banc.pdf, at 35 ($375 million settlement in similar case); *id.* at Columbia.pdf, at 25 ($140 million settlement); http://www.oag.state.ny.us/investors/alliance_cap_mgmt_aod.pdf, at 22 ($250 million settlement); *id.* at jcm/aod.pdf, at 9 ($100 million settlement); http://www.oag.state.ny.us/press/2002/may/may21a02.html ($100 million settlement in analyst conflict of interest case).

[13] See http://www.nasd.com/web/idcplg?IdcService=SSGETPAGE&nodeId=749&ssSourceNodeId=6.

[14] http://www.nyse.com/regulation/howregworks/1022221394131.html.

the standards prescribed by Congress. Together, these checks effectively curb unlawful practices and compensate injuries. Given the availability of these remedies, which deter and punish misconduct and compensate those who truly are its victims, there is no reason for this Court to permit state holder actions to unravel the litigation reforms implemented by Congress.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfuliy submitted.

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No. 04-1371

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Petitioner,

v.

SHADI DABIT, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED,
Respondent.

On a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR PHILLIP GOLDSTEIN AND BULLDOG INVESTORS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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QUESTION PRESENTED

Whether SLUSA preempts claims brought by holders of securities based upon misrepresentations, omissions, or manipulation, notwithstanding SLUSA's language limiting preemption to claims "in connection with the purchase or sale of a covered security," and this Court's interpretation of identical language to cover only claims brought by purchasers or sellers in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

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INTEREST OF AMICI CURIAE[1]

Bulldog Investors, founded in 1993, is a group of private investment funds that invest in registered closed-end mutual funds and other publicly traded companies. Bulldog Investors is a leader in shareholder activism as an investment strategy.

Phillip Goldstein is a co-founder and a principal of Bulldog Investors. He has served as a director of a number of closed-end funds and is currently a director of the Mexico Equity & Income Fund, Brantley Capital Corporation, the Emerging Markets Telecommunications Fund and the First Israel Fund. Mr. Goldstein is a widely-quoted expert on value investing, shareholder rights, and corporate governance.

SUMMARY OF ARGUMENT

Holder claims represent a residual but important class of cases which arise exclusively under state law. The kind of injury true holders typically sustain occurs through acts of corporate misfeasance or malfeasance; such injuries, being derivative in nature, are redressable under state corporation law through shareholder derivative suits. On occasion, however, securities holders are injured directly and when they are, their only recourse is direct action for damages under state law. Federal securities laws provide no remedy to holders who are not injured through their purchase or sale of a security. Similarly, state corporation law offers holders no remedy in the form of a derivative action when their injury is a direct one not derivative of an injury to the corporation itself.

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[1] This brief of *amici curiae* is submitted on behalf of Bulldog Investors and Phillip Goldstein. The parties have consented to the filing of this brief in letters filed with the Clerk. In accordance with Rule 37.6, counsel states that this brief was authored by counsel and was not authored in whole or in part by counsel for any party. No person or entity, other than *amici* and their counsel submitting this brief on behalf of *amici*, made a monetary contribution to the preparation or submission of the brief.

Holders of a security are, on occasion, the investors most severely injured by the kind of conduct the federal securities laws proscribe. The mutual fund scandal brought to light in 2003 is a perfect example of a situation in which holders are injured to a much greater degree by wrongdoing than are purchasers or sellers. As one of the district judges presiding over pending litigation arising out of that scandal wrote recently, denying holders the right to sue "would have the supremely ironic effect in this case of discriminating against victims who suffered the greater injury." *In re Mutual Funds Inv. Litig.*, 384 F.Supp.2d 845, 854 n.6 (D. Md. 2005). The Securities Litigation Uniform Standards Act of 1998 (SLUSA) does not mandate—indeed, properly construed does not permit—such a "supremely ironic effect."

The present case also demonstrates the incongruity of an interpretation of SLUSA which would deny holders any remedy under either federal or state law. Customers whom Merrill Lynch fraudulently induced to purchase junk stocks may seek redress for their injuries under the federal securities laws. Holders like Shadi Dabit, on the other hand, whom Merrill Lynch fraudulently induced to *retain* junk stocks have only those remedies that state law may grant him. Holders like Mr. Dabit are no less worthy victims than defrauded purchasers and their claims present no difficulties of proof that do not also burden purchaser plaintiffs. Yet if the Second Circuit's interpretation of SLUSA is rejected and the Seventh Circuit's accepted, defrauded purchasers will have their day in federal court, while defrauded holders will be shut out of all courts, state and federal.

There is accordingly no legitimate reason to construe the statutory language of SLUSA, which amends the 1934 Act, any differently than the identical language found in section 10(b) of the same Act. To interpret the phrase narrowly in section 10(b) (denying holders a federal cause of action) but broadly in SLUSA (preempting holders' state law causes of action) would arbitrarily extinguish *all*

holder claims of every kind, state or federal. Such a result is considerably broader than the effect SLUSA has on the claims of purchasers and sellers. Even though SLUSA preempts a purchaser's and seller's state law claims, purchasers and sellers may still assert their claims under federal law; if they cannot plead such claims in compliance with the requirements of PSLRA, then their claims are presumably the kinds of "meritless strike suits" Congress intended SLUSA to eliminate. Nothing in SLUSA's legislative history even remotely suggests that Congress had holder claims in mind when it enacted SLUSA, much less that Congress intended the wholesale obliteration of all holder claims regardless of their merit.

There is no legitimate reason to construe the operative language of SLUSA, which amends the Securities Exchange Act of 1934 Act, any differently than the identical language found in section 10(b) of the same Act. To interpret the phrase narrowly in section 10(b) (denying holders a federal cause of action) but broadly in SLUSA (preempting holders' state law causes of action) would arbitrarily extinguish *all* holder claims of every kind, state or federal. Such a result is considerably broader than the effect SLUSA has on the claims of purchasers and sellers. Even though SLUSA preempts a purchaser's and seller's state law claims, purchasers and sellers may still assert their claims under federal law; if they cannot plead such claims in compliance with the requirements of PSLRA, then their claims are presumably the kinds of "meritless strike suits" Congress intended SLUSA to eliminate. Nothing in SLUSA's legislative history even remotely suggests that Congress had holder claims in mind when it enacted SLUSA, much less that Congress intended the wholesale obliteration of all holder claims regardless of their merit.

The Second Circuit's conclusion that SLUSA does not preempt claims alleging fraud or manipulation in connection with the *retention* of securities is consistent with the historically limited reach of the federal securities law; is consistent with SLUSA's text, purpose and legislative his-

tory; is consistent with the applicable rules of statutory construction; and is consistent with the decisions of the overwhelming majority of federal courts to have addressed the issue. The decision below should accordingly be affirmed.

ARGUMENT

I. SLUSA'S TEXT, ITS LEGISLATIVE HISTORY AND RUDIMENTARY RULES OF STATUTORY CONSTRUCTION POINT TO THE CONCLUSION THAT SLUSA DOES NOT PREEMPT HOLDER CLAIMS.

A. The States have traditionally regulated securities transactions, and for more than sixty years federal securities law supplemented such state authority which Congress explicitly preserved and protected.

Prior to 1933, every aspect of securities regulation lay within the exclusive domain of the States. "Private rights of action, at common law and in equity, for persons injured in securities transactions preceded state statutes regulating the sale of securities, and many of those remedies still exist." Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1, 20 (1998) (hereinafter "Painter, *Responding*"). Shareholders were first permitted to band together against corporate managers in class actions under state law. *Id.* at 21-22. In the early twentieth century, States adopted Blue Sky laws governing securities transactions. *Id.* at 21. Limitations on the States' interstate authority hindered the effectiveness of state laws to combat securities abuses, however. "For example, because state securities commissioners could not extend their authority across state lines, state securities laws could not control two major waves of securities frauds, which took place from 1917 to 1920 and in the late 1920s." *Id.* at 22-23.

In the aftermath of the 1929 stock market crash, Congress undertook to supplement state law by regulating interstate sales of securities through enactment of the Securities Act of 1933 ("1933 Act") and Securities Exchange Act of 1934 ("1934 Act"). In both statutes, Congress expressly preserved state law. 1933 Act § 16, 48 Stat. 74, 84; 1934 Act § 28, 48 Stat. 881, 903. *See Leroy v. Great Western United Corp.*, 443 U.S. 173, 182 (1979) (savings clause served "to protect, rather than to limit, state authority"). This dual state and federal regime for the regulation of securities transactions endured from 1933 until the mid-1990's. Painter, *Responding*, 84 Cornell L. Rev. at 30-31.

The 1933 and 1934 Acts, which govern interstate sales of securities are the two major exceptions to the general rule that otherwise leaves matters of corporate law to the States. Congress has never seriously considered adopting a federal corporate law, and none of the legislation Congress has since enacted has ever purported to change this arrangement, including the reform measures of the 1990's. Painter, *Responding*, 84 Cornell L. Rev. at 15 (discussing failed legislative proposals to federalize broad segments of corporate law).

Thus, for over sixty years federal securities law augmented state law. Congress provided a private right of action under the 1933 Act for claims reaching fraud "in the offer of sale" of securities, with respect to which both state and federal courts may exercise jurisdiction. 15 U.S.C. § 77e. Congress explicitly prohibited the removal of 1933 Act cases from state to federal court. 15 U.S.C. § 77v. The 1934 Act provided additional remedies and included § 10(b), "a catch-all clause to prevent manipulative devices," pursuant to which the federal courts later found an implied right of action. Testimony of Thomas G. Corcoran, Hearing on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934) (discussing 9(c) which became § 10(b) of the 1934 Act). Congress granted federal courts exclusive jurisdiction over 1934 Act

claims. As noted above, however, Congress explicitly preserved state law in both the 1933 and 1934 Acts.

B. Congress employed § 10(b)'s extensively litigated "in connection with the purchase or sale" language to define SLUSA's pre-emptive scope.

It is against the backdrop of more than sixty years of dual state and federal regulation of securities transactions that Congress enacted SLUSA. "[I]n 1996 much of the dual-registration regime was dismantled by a Republican controlled Congress committed to reducing the regulatory burden on business. Pursuant to the National Securities Markets Improvement Act of 1996 ('1996 Act'), state blue sky laws requiring registration or merit qualification no longer apply to 'covered securities' ...." Painter, *Responding*, 84 Cornell L. Rev. at 29-30. The passage of SLUSA in 1998 preempted areas of state law.

Even the Seventh Circuit agrees that the Congressional findings in SLUSA and SLUSA's legislative history make unmistakably clear Congress' purpose in enacting SLUSA: to close a perceived "federal flight" loophole in the Private Securities Litigation Reform Act of 1995 (PSLRA). *Kircher v. Putnam Funds Trust*, 403 F.3d 478, 482 (7th Cir. 2005) ("SLUSA is designed to prevent plaintiffs from migrating to state court in order to evade rules for federal securities litigation in the Private Securities Litigation Reform Act of 1995."). Specifically, Congress was concerned that securities class action lawyers and their clients were evading the PSLRA's procedural reforms by recasting traditionally federal purchaser or seller claims as claims based upon state law and filing them in state courts where the PSLRA does not apply. In response, Congress enacted SLUSA to preempt such repackaged state law claims. SLUSA also makes any such claims filed in state court removable to federal court. SLUSA thus makes the remedies provided under federal securities laws the sole remedies available to most securities purchasers and sellers who file their claims as class

actions. "Because most plaintiffs find litigation outside of a class action impractical and uneconomical, the vast majority of investors will be left with only federal remedies—the express remedies created by the [1933 Act] and the remedies that the federal courts have implied under the [1934 Act]." Painter, *Responding*, 84 Cornell L. Rev. at 2.

SLUSA does not, however, make federal court the exclusive venue for all securities class actions. For instance, because SLUSA only preempts and makes removable covered class actions based on state law, class actions based on the 1933 Act may still be prosecuted in state court, and they cannot be removed to federal court either on federal question grounds (as has always been the case) or under SLUSA. *See Williams v. AFC Enters., Inc.*, 389 F.3d 1185 (11th Cir. 2004) (dismissing for lack of appellate jurisdiction appeal of remand order in 1933 Act class action). SLUSA also contains a so-called "Delaware carve-out" provision exempting state law-based class actions in which the plaintiffs allege that corporate managers made misleading statements in order to obtain shareholder approval of a transaction.

> The Delaware carve-out was adopted because of concerns expressed by SEC Chairman Arthur Levitt ... and others, that *earlier drafts of the bills in both the House and the Senate threatened to dismember state corporate law by forcing claims involving breach of the fiduciary duty of disclosure to be filed in federal court.* For example, earlier versions of the bills probably would have preempted a class action, under Delaware law, against corporate directors for breach of the fiduciary duty of disclosure to shareholders in connection with a merger or other change-in-control transaction.

Painter, *Responding*, 84 Cornell L. Rev. at 67 n.355 (emphasis added).

The version of SLUSA Congress finally adopted preempts a precisely defined set of "covered class actions" in which "any private party alleg[es]" either "a misrepresentation or omission of a material fact in connection with

the purchase or sale of a covered security" or the use of "any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1); *see also* 15 U.S.C. § 77p(b).

The "in connection with the purchase or sale" language is "language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits." *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342-43 (11th Cir. 2002). *Accord Green v. Ameritrade, Inc.*, 279 F.3d 590, 597 (8th Cir. 2002) ("The Supreme Court has clearly explained the meaning of this language in the context of SEC Rule 10b-5 and § 10(b)."); *Dabit v. Merrill Lynch, Pierce, Fenner & Smith*, 395 F.3d 25, 34, 35 (2d Cir. 2005) ("The phrase has been extensively interpreted by the Supreme Court and the lower federal courts in the context of § 10(b) and Rule 10b-5" and "In enacting SLUSA, ... Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention").

Significantly, this Court's interpretation of that phrase in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), specifically held that the phrase does *not* include holders who "decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material." *Id.* at 737-38. "[T]he 'normal rule of statutory construction' [is] that 'identical words used in different parts of the same act are intended to have the same meaning.'" *Gustafson v. Alloyd Co.*, 513 U.S. 561, 570 (1995) (quoting *Department of Revenue of Or. v. ACF Indus., Inc.*, 510 U.S. 332, 342 (1994)). SLUSA's legislative history confirms the propriety of interpreting the phrase "in connection with the purchase or sale" the same in § 10(b) and SLUSA.

C. Holder claims were not part of the legislative bargain that produced SLUSA and are therefore not pre-empted by SLUSA, as the Second Circuit correctly concluded.

No one has seriously questioned Congress' focus in enacting SLUSA and the text of SLUSA itself, which sets forth Congress' findings, leaves no room for doubt:

> [S]ince enactment of [the PSLRA], considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts; this shift has prevented that Act from fully achieving its objectives.

15 U.S.C. § 78a(2) & (3). Thus, Congress found "it is appropriate to enact national standards for securities class action lawsuits," "to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995." *Id.* at § 78a(5). *See* 144 Cong. Rec. (Oct. 15, 1998) H11019-01, H11020 (Joint Explanatory Statement of the Committee of Conference) ("The purpose of this title is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court.") S. Rep. No. 105-182, 1998 WL 226714, at *9 (1998) ("This legislation is designed to address an unforeseen 'loophole' in the 1995 Private Securities Litigation Act, that has blocked that law from accomplishing its stated goal of reforming private securities litigation.").

SLUSA's objective of closing the "federal flight" loophole was the explicit understanding of the Act's proponents. "Only those suits traditionally filed in Federal courts would be affected by H.R. 1689, while those claims that historically have been pursued in State courts would be left undisturbed." 144 Cong. Rec. E1385 (July 22, 1998) (Rep. Fazio):

> [SLUSA preempts] only those class actions that have recently migrated to State court, while *leaving traditional State court actions and procedures solidly in*

> *place.* ... This legislation has been carefully crafted only to affect those types of class actions that are appropriately heard on the Federal level.

143 Cong. Rec. S10477 (Oct. 7, 1997) (Sen. Dodd) (emphasis added).

Accordingly, SLUSA was not the "federal power grab" that respondent and its *amici* make it out to be; Congress was concerned strictly with "returning to federal courts cases which until the 1995 Reform Act had always been heard in federal courts." 144 Cong. Rec. E1390 (July 22, 1998) (Rep. Eshoo).

Moreover, SLUSA's text and legislative history are as significant for what they *do not* say as they are for what they do say. SLUSA never mentions claims "in connection with" the *retention*—as opposed to the purchase or sale—of a security. Similarly, nowhere in SLUSA's legislative history are such state law claims ever mentioned. Any Congressional intent to preempt such claims is thus at best ambiguous. It is far more likely that Congress simply gave no thought at all to holder claims. Given that such suits are a relative rarity, given that they were clearly not the impetus behind the enactment of SLUSA, and given the legislative record's silence with respect to such claims, there is no reason to believe that holder suits played any part of the legislative bargain that produced SLUSA.

Moreover, though there may well be members of Congress who would like to eliminate holder claims entirely, it is far from certain that such a measure could win a legislative majority, particularly in view of the fact that at least some of SLUSA's supporters understood SLUSA to "leav[e] traditional State court actions and procedures solidly in place. ..." 143 Cong. Rec. S10477 (Oct. 7, 1997) (Sen. Dodd). It is anyone's guess how the legislative process might treat holder claims. Perhaps an elimination of state law holder claims would come at the price of granting holders a 10b-5 type remedy subject to the same kinds of restrictions as 10b-5 purchaser and seller claims. Or Congress might conclude that state law holder class ac-

tions do not present the same dangers as those class actions targeted by SLUSA and therefore do not warrant any Congressional action. Whatever bargain members of Congress might strike with respect to holder claims, it remains within that body's province—not the courts'—to decide the fate of holder claims, insofar as federal law is concerned.

Two rules of statutory construction also counsel against an interpretation of SLUSA which would preempt holder claims. First, "in all pre-emption cases, and particularly in those [where] Congress has legislated ... in a field which the States have traditionally occupied, we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996). The assumption applies not only "to the question whether Congress intended any pre-emption at all," but also "to questions concerning the *scope*" of an express preemption statute. *Id.* at 485 (emphasis in original) (citing *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 518, 523 (1992) (where the Court "used a 'presumption against the preemption of state police power regulations' to support a narrow interpretation of such an express" preemption statute)).

Second, when doubts exist about Congress' intent to preempt state law, courts must err on the side of caution. "An unexpressed purpose of Congress to set aside statutes of the states regulating their internal affairs is not lightly to be inferred and ought not to be implied where the legislative command, read in the light of its history, remains ambiguous." *Penn Dairies v. Milk Control Comm'n*, 318 U.S. 261, 275 (1943). At the very least, SLUSA's text, its legislative history and these basic interpretive rules cast serious doubt upon the proposition that SLUSA preempts the state law claims of holders in connection with their retention of securities. Respondent and its *amici*

have offered no persuasive justification to overcome this logic.

II. HOLDER CLASS ACTIONS PRESENT THEMSELVES IN A VARIETY OF FACTUAL CONTEXTS UNDER A VARIETY OF STATE LAW THEORIES

Class action holder claims under state law have presented themselves in a variety of forms and factual circumstances. For instance, in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), the president and chairman of Newport Steel Corporation rejected another steel company's merger offer which would have been highly profitable to Newport stockholders. Before the month was out, he had sold for double market value his 40% holdings in Newport to a third company which also desired to gain control of Newport. After finding themselves "without federal remedies," the *Birnbaum* plaintiffs secured "recovery in a cause of action based on state law. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9 (1975) (citing 3 L. Loss, Securities Regulation 1469 (2d ed. 1961)).

Perhaps the most common context in which holder claims arise is when holders are induced "not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material." *Id.* at 737-38. That was the case in *Weinberger v. Kendrick*, 698 F.2d 61 (2d Cir. 1982). W.T. Grant Company filed for bankruptcy with well over a billion dollars in recorded liabilities. Prior to that time, Grant had offered its shareholders a misleadingly optimistic picture of the company's financial position at a time when the company's actual position continued to deteriorate. The class included "persons who merely *held*, rather than *purchased*, Grant securities during the class period," who asserted common law fraud and breach of fiduciary duty claims. *Id.* at 68 (emphases in original). The holders in *Weinberger* shared in the class recovery strictly by virtue of their state law claims. In a

comprehensive opinion by Judge Henry Friendly for the Second Circuit, the court upheld a class settlement of those holder claims. *Id.*

California is the most recent state to recognize holder claims under state law. *Small v. Fritz Cos.*, 65 P.3d 1255 (Cal. 2003). In *Small*, the plaintiff alleged "that defendant corporation and its officers sent its stockholders a fraudulent quarterly financial report that grossly overreported earnings and profits. Plaintiff alleged that when the fraud was discovered, the price of the corporate stock dropped precipitously, causing injury to stockholders like himself." *Id.* at 1256. Small filed "a class action on behalf of all shareholders in Fritz 'who owned and held Fritz common stock ... in reliance on defendants' material misrepresentations and omissions ....'" *Id.* at 1258. Small asserted claims for common law fraud and negligent misrepresentation, and for violations of California statutory provisions "which codify the common law actions for fraud and deceit." *Id.*

The California supreme court rejected the defendants' arguments against the allowance of holder claims:

> California has long acknowledged that if the effect of a misrepresentation is to induce forbearance—to induce persons not to take action—and those persons are damaged as a result, they have a cause of action for fraud or negligent misrepresentation. We are not persuaded to create an exception to this rule when the forbearance is to refrain from selling stock. This conclusion does not expand the tort of common law fraud, but simply applies long-established legal principles to the factual setting of misrepresentations that induce stockholders to hold on to their stock.

65 P.3d at 1257. The court was careful to limit the availability of such a claim "to stockholders who can make a bona fide showing of actual reliance upon the misrepresentations," *id.*, but expressed no view as to the propriety of certification of the case as a class action because the

trial court had not yet "ruled on the matter." *Id.* at 1256 n.1.

A case involving strikingly similar holder allegations to the present case is also pending before this Court on a petition for a writ of certiorari. *Disher v. Citigroup Global Markets, Inc.*, 419 F.3d 649 (7th Cir. 2005), *petition for cert. pending*, No. 05-776 (U.S. filed Dec. 15, 2005). The primary difference between *Disher* and *Dabit* is that Disher's complaint actually excluded all purchasers and sellers in his complaint; he defined his class as one consisting exclusively of non-trading shareholders, as the Seventh Circuit recognized. *Id.* at 651. The Seventh Circuit, in conflict with the Second Circuit's *Dabit* decision, held that SLUSA preempts such claims.

A final group of holder class actions which the Court should consider are cases involving the mutual fund scandal which surfaced in 2003. Many of those cases have been consolidated in a multidistrict proceeding currently pending before three district judges in the District of Maryland. *See In re Mutual Funds Inv. Litig.*, 384 F.Supp.2d 845 (D. Md. 2005). Those cases involve holders whose mutual fund holdings were diluted by arbitrage practices known as "market timing" and "late trading." *Id.* at 852 n.1 (describing both practices). Another group of mutual fund class actions involving holder claims of market timing are also currently pending before the Court on a petition for a writ of certiorari. *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005), *petition for cert. pending*, No. 05-409 (U.S. filed Sept. 29, 2005). In those cases, the holder-plaintiffs have asserted a variety of state law theories of recovery against the defendant Funds and their managers for permitting market timing and late trading in the funds, including breach of contract, breach of fiduciary duty and negligence.

CONCLUSION

Holder claims, unlike the state law claims which SLUSA was designed to preempt, are not mere 10b-5 claims recast as state law claims. They have not been "traditionally" litigated in federal court or under federal law. To the extent they are available at all, they have only existed under state law. Whether such claims should be permitted is a question either for the States; whether they should be preempted is a question for Congress. SLUSA does not preempt such claims. The decision below should accordingly be affirmed.

Respectfully submitted,

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BRIEF FOR IJG INVESTMENTS AND IRLYS GUY AS *AMICUS CURIAE* SUPPORTING RESPONDENT

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QUESTION PRESENTED

Whether the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, preempts state law class action claims based upon allegedly fraudulent statements or omissions brought solely on behalf of persons who were induced thereby to hold or retain (and not purchase or sell) securities?

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INTEREST OF *AMICUS CURIAE* IJG INVESTMENTS AND IRLYS GUY

On June 7, 2002, *amicus curiae* IJG Investments Limited Partnership and Irlys Guy (collectively "the IJG Group")[1] filed a complaint in Minnesota state court. The IJG Group asserted state law claims alleging that, as customers of Merrill Lynch & Co., Inc. ("Merrill" or "Petitioner"), they were overcharged for the research that Merrill provided. On July 3, 2002, Merrill removed the case to the United States District Court for the District of Minnesota, alleging both that the IJG Group's state law claims were preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227, and that federal diversity jurisdiction exists. On November 4, 2002, the Judicial Panel on Multi-District Litigation entered a conditional order transferring this case to the Southern District of New York and assigned it to the Honorable Milton Pollack, Senior District Judge, for coordinated proceedings with a number of actions, including the case filed by Respondent Shadi Dabit. On April 10, 2003, Judge Pollack dismissed the IJG Group's complaint, in an order that included the dismissal of Shadi Dabit's claims, finding that SLUSA preempted the claims. The IJG Group and Dabit each appealed the dismissal of their separate claims to the United States Court of Appeals for the Second Circuit.

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[1] Pursuant to S.Ct. Rule 37.6, *amicus curiae*, IJG Investments and Irlys Guy, state that no other persons or entities made any monetary contribution to the preparation or submission of this brief. Counsel for IJG Investments and Irlys Guy wholly authored this brief.

The Court of Appeals coordinated briefing and argument on the two appeals.[2] On January 11, 2005, the Second Circuit issued an opinion ruling on both Respondent's and the IJG Group's appeals as to each case, affirming the district court in part and vacating and remanding in part. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005), *cert. granted*, 126 S. Ct. 34 (Sep. 27, 2005). The Second Circuit held that this Court's ruling in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), "applies as a limit on SLUSA's 'in connection with' requirement such that SLUSA does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members." *Id.* at 28. With respect to the IJG Group's allegations, the Second Circuit held that the IJG Group's commissions-based claims were preempted by SLUSA because "they necessarily involve allegations of a purchase or sale of securities 'in connection with' this alleged misconduct." *Id.* at 48. However, the Second Circuit determined that SLUSA does not apply to claims relating to flat annual fees paid for Merrill's services. *Id.* at 48, 49 ("An annual fee for services is paid whether or not the customer transacts on the account, and the misrepresentations inherent in the alleged nonperformance and statutory violations therefore do not necessarily 'coincide[] with' a securities transaction.") (citations omitted). The Second Circuit vacated the lower court's dismissal in this regard, with instructions that the district court "grant IJG's motion for remand as to so much of the

[2] Dabit and the IJG Group submitted separate briefs.

claim as seeks recovery on behalf of a putative class of those who paid annual fees." *Id.* at 50; *see also id.* at 28.[3]

Merrill filed the petition now before this Court only with respect to the Second Circuit's ruling in Dabit's case. The IJG Group submits this brief as *amicus curiae* in support of Respondent.

The Petition before this Court involves the extent to which SLUSA preempts class actions brought under state law where those actions do not allege that class members purchased or sold particular securities. The question presented turns on this Court's interpretation of SLUSA's "in connection with" the purchase or sale of a covered security language and whether this Court's decision in *Blue Chip Stamps* applies to the interpretation of the scope of SLUSA's preemption of private class action claims. Although this case arises before the Court in the context of whether SLUSA preempts claims of "holders" of securities, the answer can affect other claims, including the claims that the IJG Group asserted against Merrill. Accordingly, the IJG Group submits this brief as *amicus curiae* in support of Respondent's position. Petitioner and Respondent both consented to the filing of *amicus* briefs in support of either party. *See* Consent by Respondent, filed Oct. 17, 2005 and Consent by Petitioner, filed Oct. 18, 2005.

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[3] The Second Circuit dismissed Shadi Dabit's "holding" claims as pleaded, concluding that the "'holding' class as defined includes purchasers and thus that the putative class action includes allegations triggering SLUSA preemption." *Dabit*, 395 F.3d at 44. The Second Circuit vacated the lower court's ruling and remanded for dismissal without prejudice so that Dabit may replead. *Id.* at 28.

SUMMARY OF ARGUMENT

Congress enacted SLUSA for a specific purpose: to close the "federal flight" loophole that resulted in private plaintiffs avoiding the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), Pub. L. No. 104-67, 109 Stat. 737, by filing class actions in state court. Congress addressed this specific problem in a specific way, by forcing class action securities claims by private litigants into federal court. Contrary to the arguments made by Merrill, applying *Blue Chip Stamps*' purchaser-seller requirement in interpreting SLUSA is supported by both case law and statutory construction, particularly given SLUSA's express language and purpose. *Blue Chip Stamps* acts as a limit to plaintiffs' pursuit of claims under the federal securities laws, the very claims that Congress wants in federal court. However, nothing in SLUSA's language suggests that Congress sought to use SLUSA to go beyond eliminating the federal flight loophole by preventing private plaintiffs from pursuing claims that *Blue Chip Stamps* and federal law had left for the states.

ARGUMENT

I. SLUSA'S PREEMPTION IS LIMITED AND DESIGNED TO EFFECTUATE THE PURPOSES OF THE FEDERAL SECURITIES LAWS.

In 1995, Congress passed the PSLRA to address perceived problems with class action claims brought by private litigants under federal securities laws in federal court. The PSLRA included, among other things, stringent pleading standards for federal securities claims in federal court. *Spielman v. Merrill Lynch, Pierce, Fenner & Smith*, 332 F.3d 116, 122 (2d Cir. 2003). To avoid PSLRA's federal

requirements, some private litigants migrated to state court, seeking to take advantage of more favorable state laws. Congress enacted SLUSA for a specific purpose: to close the perceived loophole in enforcement of the PSLRA by making federal courts the exclusive venue and federal law the exclusive source of remedy for certain types of class action claims. *See Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 189 F. Supp. 2d 14, 16 (S.D.N.Y. 2001) ("Congress passed SLUSA in order to prevent plaintiffs from bringing traditional securities actions in state courts."); *accord Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 124 (2d Cir. 2003); *French v. First Union Sec., Inc.*, 209 F. Supp. 2d 818, 823 (M.D. Tenn. 2002).

When Congress sought, through SLUSA, to attack this loophole, it used a scalpel not a sword. Instead of broadly preempting state law, Congress specifically limited SLUSA to the kind of litigation it wanted in federal court: class actions by private plaintiffs alleging claims in connection with the purchase or sale of a "covered security." *See* 15 U.S.C. § 77p(b) and 78bb(f)(1). SLUSA is not, nor was it intended to be, a blanket immunity from suit under state statutes or common law, applicable to any complaint against a brokerage house. Rather, SLUSA addresses a specific problem in a specific way, requiring a specific subset of claims to be filed in federal courts under federal law in federal procedure.

To accomplish this goal, Congress chose to focus on a procedural matter, and did not choose to broadly preempt state law. *See Prof'l Mgmt. Assoc. Inc. Employees' Profit Sharing Plan v. KPMG L.L.P.*, 335 F.3d 800, 803-04 (8th Cir. 2003), *cert. denied*, 540 U.S. 1162 (2004) ("[SLUSA] simply establishes a procedural rule regarding the filing of

class action lawsuits alleging securities fraud" so no retroactivity analysis was warranted). Thus, SLUSA applies, by its terms, only if a private plaintiff alleges that the claims in the complaint should be adjudicated using the class action procedural device. *Spielman*, 332 F.3d at 123-24. All other things being equal, two plaintiffs could assert the same state law claims, but if one of the plaintiffs includes class procedural allegations, SLUSA might apply. The other plaintiff, however, would be free to pursue state remedies. The "uniformity" that Congress sought to achieve through SLUSA is somewhat limited in the sense that it relates only to private plaintiffs' class action claims that would be governed by the PSLRA if they were filed in federal court, *i.e.*, claims that private class action plaintiffs have standing to assert as purchasers and sellers of securities under established federal law.

Just as Congress could have provided that SLUSA applies broadly to preempt state law irrespective of whether claims are brought individually or on behalf of a class, Congress could have also provided that SLUSA's preemption applies to a private plaintiff irrespective of whether a purchase or sale of securities is alleged. Consistent with its specific, limited goal of closing the federal flight loophole, Congress placed within SLUSA the identical limitation it had placed in other federal securities laws: SLUSA is only applicable to private claims alleging a fraud or misrepresentation "in connection with" the purchase or sale of securities. *See* 15 U.S.C. § 77p(b) and § 78bb(f)(1). As a matter of statutory construction, Congress is presumed to have known how the language it selected applies to a private plaintiff, as interpreted by *Blue Chip Stamps*. *See, e.g., Riley v. Merrill Lynch, Pierce,*

Fenner & Smith, Inc., 292 F.3d 1334, 1342 (11th Cir. 2002), *cert. denied*, 537 U.S. 950 (2002). As several courts have noted, "[i]n enacting the SLUSA, the legislative branch must have been aware of the interpretation of section 10(b) of the 1934 Act, which recognized causes of actions for the nonpurchase or nonsale of securities were not covered by the 1934 Act and state law would fill those gaps." *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 595 (W.D. Tex. 2001); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598 (8th Cir. 2002) (virtually identical language). Thus,

> SLUSA only converts into federal claims those state claims that fall within its clear preemptive scope, thereby confining federal question jurisdiction under this statutory regime to a subset of securities fraud cases. Congress was mindful to preserve the balance between establishing and maintaining "national standards for securities class action lawsuits involving nationally traded securities" and "preserving the appropriate enforcement powers of state securities regulators. . . ." This balance was achieved by expressly confining SLUSA preemption and removal to lawsuits in which the plaintiff alleges a state law violation stemming from (for purposes of this suit) "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security."

Spielman, 332 F.3d at 124 (citations omitted).

II. THE SECOND CIRCUIT PROPERLY CONSTRUED *BLUE CHIP STAMPS* AS A LIMIT ON SLUSA PREEMPTION.

In *Blue Chip Stamps*, this Court held that private securities litigation under Section 10(b) and Rule 10b-5 is limited to claims based upon the actual purchase or sale of securities.[4] *Blue Chip Stamps*, 421 U.S. at 749; *see also Superintendent of Ins. of New York v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971) (plaintiffs' injuries must result from deceptive practices "in connection with," or that touch plaintiffs purchase or sale of securities). In so holding, this Court expressed concern that an expansion of federal securities litigation beyond actual purchasers and sellers of securities could result in "endless case-by-case erosion" of the statutory language, which explicitly limits the reach of Section 10(b) and Rule 10b-5 to the "purchase or sale of any security." *See Blue Chip Stamps*, 421 U.S. at 755; *accord SEC v. Zandford*, 535 U.S. 813, 820 (2003) ("in connection with" provision "must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b)").

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[4] Specifically, *Blue Chip Stamps* affirmed the correctness of the "Birnbaum rule," established by the Second Circuit, which it characterized as follows:

> Since both § 10(b) and Rule 10b-5 proscribed only fraud "in connection with the purchase or sale" of securities, and since the history of § 10(b) revealed no congressional intention to extend a private civil remedy for money damages to other than defrauded purchasers or sellers of securities, in contrast to the express civil remedy provided by § 16(b) of the 1934 Act, the court concluded that the plaintiff class in a Rule 10b-5 action was limited to actual purchasers and sellers.

421 U.S. at 731.

Given that claims of nonpurchasers and nonsellers have been left to state law, and given SLUSA's language and specific purpose, the Second Circuit properly rejected Merrill's argument that the *Blue Chip Stamps*' purchaser-seller rule applies only to standing under the federal securities laws and not to SLUSA's substantive application. The same statutory limitation found in the securities laws and addressed in *Blue Chip Stamps* is found in SLUSA, which limits preemption to claims "in connection with the purchase or sale of a covered security." 15 U.S.C. § 77p(b) and § 78bb(f)(1). The Second Circuit reasoned that, in choosing the "in connection with" language of Section 10(b), "Congress employed language with a settled judicial interpretation of which *Blue Chip* was a part and we see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish nonpurchaser and nonseller state class action claims." *Dabit*, 395 F.3d at 39. To the contrary, since only purchasers and sellers have access to a private damages remedy under federal law, as the Second Circuit concluded, "it is far more natural to suppose that Congress meant to import the settled standing rule along with the 'in connection with' phrase as a substantive standard." *Id.* at 40.

Merrill further argues that policy considerations weigh heavily against the Second Circuit's interpretation, arguing, *inter alia*, that it would allow certain categories of "vexatious" litigation to go forward. *See* Merrill Petition at 40 ("Holder claims present the greatest risk for the type of vexatious securities litigation that Congress sought to eliminate when it enacted SLUSA."). This Court cannot

import into the statute a policy consideration where Congress itself failed to do so. As the Second Circuit noted:

> The question in interpreting ambiguous statutory language, however, is not what Congress might sensibly want to do, but what Congress did. . . . As noted, Congress defined SLUSA's preemptive scope by borrowing language with a settled judicial interpretation in the context of private damages actions, and such borrowing implicates the strong presumption that Congress is aware of and approves that construction. Under that construction, the Supreme Court held that the judicially-adopted bar on federal non-purchaser and non-seller claims was counterbalanced by the existence of remedies under state law.

Dabit, 395 F.3d at 40 (citations omitted).

Consistent with the Court's holding in *Blue Chip Stamps* and other precedent interpreting the language of Section 10(b) and Rule 10b-5 as applied to private plaintiffs, SLUSA preemption does not extend to claims that do not allege a purchase or sale of covered securities. *See Green*, 279 F.3d at 598; *Gordon v. Buntrock*, No. 00 CV 303 (SAS), 2000 WL 556763, at *14 (N.D. Ill. April 28, 2000).

Merrill contends that a plain reading of SLUSA would allow for preemption of claims, such as Dabit's "holding" claims even though no purchase or sale of a security took place. *See* Merrill Petition at 21. To the contrary, Merrill's argument that claims such as Dabit's, which involve no purchase or sale of a security, should be preempted unreasonably re-writes SLUSA. Congress did not make SLUSA applicable to claims that are "in connection with securities." Rather, the statute applies to claims "in connection

with the *purchase* or *sale*" of securities. *See* 15 U.S.C. § 77p(b) and § 78bb(f) (emphasis added). A number of cases applying SLUSA's scope have looked to whether the state law claims are based on a purchase or sale of securities.

In the typical securities case that Congress sought to address in SLUSA, the claim is that the defendant misrepresented the value of a particular stock, thereby causing the plaintiff to purchase the stock and suffer damages caused by a drop in stock price. *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith*, No. 01-Civ. 3013 (DLG), 2001 U.S. Dist. LEXIS 15943, *9-10 (S.D.N.Y. Oct. 9, 2001). Courts confronted with this fact pattern routinely find that the misrepresentation at issue is "in connection with" the purchase or sale of securities. *Id.* at *10. Accordingly, when the same fact pattern is alleged in support of state law claims, courts routinely find the SLUSA "in connection with" requirement satisfied and the claim preempted. *See, e.g., Riley*, 292 F.3d at 1347.[5]

In other securities cases, while the misrepresentation at issue may not concern the value of a particular stock, *per se*, the claim nevertheless involves the purchase or sale of a particular stock as a result of the misrepresentation. *See, e.g., Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615 (9th Cir. 1981); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980). There are similar cases in the SLUSA context, *i.e.*, cases where the misrepresentation is not about the value of the stock *per se*, but

[5] *See also Feitelberg v. Merrill Lynch & Co., Inc.*, 234 F. Supp. 2d 1043 (N.D. Cal. 2002) (plaintiffs sought "restitution" of trading losses as well as "disgorgement" of profits); *Korsinsky v. Salomon Smith Barney Inc.*, 2002 WL 27775 (S.D.N.Y. January 10, 2002) (plaintiffs sought damages in the form of investment losses).

there is an allegation that an alleged misrepresentation caused the purchase of securities. *See, e.g., Behlen v. Merrill Lynch*, 311 F.3d 1087 (11th Cir. 2002); *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875 (8th Cir. 2002).

However, SLUSA preemption does not extend to state law claims without a purchase or sale of securities. For example, in *Green v. Ameritrade, Inc.*, 279 F.3d 590 (8th Cir. 2002), the plaintiff alleged that his broker promised to provide him with access to "real time" stock quotes, but failed to deliver the information as promised. In the initial complaint, the *Green* plaintiff alleged that he purchased or sold securities, but omitted those allegations after the district court gave him the opportunity to amend the complaint. *Id.* at 598. The defendant argued that, even though the plaintiff had not alleged that he bought securities based on the real time quotes, the purpose of the quotes was to assist in determining what securities to buy and, thus, delivery of the quotes was in connection with the purchase and sale of securities. *Id.* at 597. The Eighth Circuit, however, concluded that SLUSA did not preempt the amended complaint, rejecting the suggestion that a purchase or sale should be read into the amended complaint. *Id.* at 599.

The Eighth Circuit explained that it was not enough that the product was generally of the type relied upon by investors. Instead, there must be an allegation that someone purchased or sold the stock in reliance on the quotes in order to satisfy the "in connection with" requirement under SLUSA. The court explained:

> [Defendant] does not argue that [the plaintiff's] amended complaint alleges that he or putative class members used price information provided by the real-time quote service to purchase or sell

> any particular security; instead, [defendant] asserts that consumers in general use that kind of information to purchase and sell securities, and therefore SLUSA applies to the provision of that information in this case. This argument highlights [defendant's] failure to understand the showing necessary to satisfy the "in connection with the sale or purchase of a covered security" criterion of SLUSA.
>
> * * *
>
> [T]he critical question is whether [the plaintiff's] amended complaint can reasonably be read as alleging a sale or purchase of a covered security made in reliance on the allegedly faulty information provided to himself and to putative class members by [defendant].

Green, 279 F.3d at 597-98. Thus, the court held that the plaintiff's claim was not "in connection with" a purchase or sale of securities because there was no purchase or sale of securities.

III. THIS COURT'S DECISION IN *SEC V. ZANDFORD* DOES NOT EXPAND THE SCOPE OF THE SLUSA PREEMPTION.

Contrary to Merrill's assertion, this Court's holding in *SEC v. Zandford*, 535 U.S. 813 (2002), does not change the analysis of SLUSA's preemption. *See* Merrill Petition at 25. In *Zandford*, the SEC alleged that the defendant engaged in a scheme to defraud an investor whereby he wrongfully sold stock to convert it for his own benefit. 535 U.S. at 815. In that case, the issue before this Court was whether, in the context of a motion to dismiss, the SEC had adequately pleaded a claim. *Id.* at 818. Although this Court in *Zandford* held that the alleged deceptive practice

was "in connection with" the purchase or sale of securities, *id.* at 825, the Court stated that its holding should not convert every claim against a broker into a federal securities claim, *id.* at 825 n.4. Likewise, *Zandford* cannot be read so broadly that SLUSA applies to preempt claims of a private plaintiff, irrespective of whether the plaintiff alleges a purchase or sale of securities.

CONCLUSION

For the foregoing reasons, this Court should uphold the decision of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Petitioner,

v.

SHADI DABIT,
Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Second Circuit

BRIEF FOR THE INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether class actions brought under state law by non-transacting "holders" of securities are precluded by the Securities Litigation Uniform Standards Act of 1998 (SLUSA).

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BRIEF FOR THE INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE IN SUPPORT OF PETITIONER

The Investment Company Institute (ICI), as *amicus curiae*, respectfully submits that the decision below should be reversed insofar as it holds that state-law "holder" class actions are not precluded by federal law.[1]

INTEREST OF AMICUS

ICI is the national association of the United States investment company industry. ICI's members include mutual funds, closed-end investment companies, exchange-traded funds, and unit investment trusts. ICI's mutual fund members manage more than eight trillion dollars on behalf of 90 million individual investors in nearly half of American households. ICI, *2005 Investment Company Fact Book* 3 & 29, http://www.ici.org/statements/res-/2005_factbook.pdf. Due to their diversification, professional management, and varying investment objectives, mutual funds are the investment vehicle of choice for great numbers of Americans from every walk of life, particularly as they build savings for retirement security. Today, mutual funds make up 43 percent

[1] Pursuant to this Court's Rule 37.6, ICI states that no party's counsel authored this brief in whole or in part, and no person or entity, other than ICI and its members, made a monetary contribution to the preparation or submission of this brief. Counsel of record for both petitioner and respondent have consented to the filing of this brief in letters that have been lodged with the Clerk.

of the $3.5 trillion in IRAs and about half of the $2.1 trillion in 401(k) plans. *Id.* at 39 & 41.

ICI members are significant issuers of securities. In recent years, long-term mutual funds have sold more than $1.4 trillion in new shares annually. *2005 Investment Company Fact Book* 76-77. Unlike other issuers, mutual fund operations are subject to each of the four major federal securities laws. Mutual funds are registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940, which subjects them to detailed statutory and regulatory prescriptions regarding their structure, operations, and governance; mutual fund shares must be registered under the Securities Act of 1933; the offer and sale of mutual fund shares are governed by the Securities Exchange Act of 1934; and the investment advisers to mutual funds are regulated under the Investment Advisers Act of 1940. In addition to this comprehensive federal regulation of mutual funds, each State's securities regulator has authority to investigate and bring enforcement actions with respect to fraud and deceit. 15 U.S.C. § 77r(c)(1).

ICI members are also significant purchasers, sellers, and holders of nationally traded securities. On average, ICI members account for 10 percent or more of the annual dollar volume of stock purchases and sales on the U.S. stock exchanges. Moreover, mutual funds hold 22 percent of the outstanding corporate equity in the United States, as well as large amounts of publicly traded debt securities. *2005 Investment Company Fact Book* 6-7.

Since ICI's founding over 60 years ago, one of its main objectives has been to protect and affirmatively advance the interests of mutual fund shareholders through advocacy directed at ensuring a sound legal and regulatory framework for the mutual fund industry. In pursuit of this objective, ICI regularly engages in legislative, regulatory, and other initiatives aimed at increasing government and public awareness of issues affecting investment companies and their shareholders.

STATEMENT

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA) to deter meritless lawsuits alleging securities fraud. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 31-32 (1995); *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 978-79 (9th Cir. 1999). Among other significant reforms, the PSLRA imposed new and rigorous pleading requirements for securities fraud actions (15 U.S.C. § 78u-4(b)(1)-(2)) and an automatic stay of discovery until any motions to dismiss have been resolved (15 U.S.C. §§ 77z-1(b) & 78u-4(b)(3)). To avoid the PSLRA requirements, securities plaintiffs increasingly began filing suit in state court, where the PSLRA does not apply. *Riley* v. *Merrill Lynch, Pierce, Fenner & Smith*, 292 F.3d 1334, 1341 n.12 (11th Cir. 2002) ("the decline in federal securities class action suits that occurred after the passage of the PSLRA was accompanied by a nearly identical increase in state court filings"); *see* H.R. Conf. Rep. No. 105-803, at 14 (1998) ("Prior to the passage of the [PSLRA], there was essentially no significant securities class action litigation brought in State court"). These state-court lawsuits presented precisely the opportunities for abuse that Congress had sought to curb by enacting the PSLRA. *Id.* at 13-14.

In response to this widespread evasion of the PSLRA by state-court litigation, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to "establish[] uniform national rules for securities class action litigation involving our capital markets." H.R. Conf. Rep. No. 105-803, at 13. In so doing, Congress explained that "in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA], it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities." SLUSA § 2(5), 112 Stat. 3227. To accomplish this goal, SLUSA provides that "[n]o covered class action based upon the statutory or common law of any State ... may be maintained in any State or Federal court by any private party alleging" misrepresentations or manipulation "in

connection with the purchase or sale" of covered securities, including mutual fund shares. 15 U.S.C. §§ 77p(b) & 78bb(f)(1).

SLUSA's description of the class actions within its preclusive reach—*i.e.*, those alleging a "misrepresentation or omission of a material fact," or a "manipulative or deceptive device or contrivance," occurring "in connection with the purchase or sale" of securities—was borrowed from Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, the basic anti-fraud provisions of the federal securities laws. In *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), this Court held that a private plaintiff cannot maintain a Rule 10b-5 action unless the plaintiff is a purchaser or seller of securities. This judicially created rule of standing is "inapplicable," however, in actions to enforce Rule 10b-5 by public prosecutors. *United States* v. *Naftalin*, 441 U.S. 768, 774 n.6 (1979). The question in this case is what relevance, if any, the *Blue Chip Stamps* purchaser/seller standing limitation has to the scope of SLUSA preclusion. Pet. i.

The court below held that "the purchaser-seller rule of [*Blue Chip Stamps*] applies as a limit on SLUSA's 'in connection with' requirement such that SLUSA does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members." Pet. App. 4a. The Seventh Circuit, by contrast, has concluded that "SLUSA is as broad as § 10(b) itself and that limitations on private rights of action to enforce § 10(b) and Rule 10b-5"—including particularly the *Blue Chip Stamps* purchaser/seller standing limitation—"do not open the door to litigation about securities transactions under state law." *Kircher* v. *Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005), *cert. pending*, No. 05-409.

SUMMARY OF ARGUMENT

SLUSA provides that class actions alleging securities fraud must proceed in federal court pursuant to the PSLRA, if at all; at the same time, it expressly exempts a number of

traditional state-law remedies. The additional extra-statutory exemption for state-law "holder" class actions recognized by the court below is (1) inconsistent with SLUSA's statutory text and structure; (2) unsupported by its legislative history; and (3) unwarranted and unnecessary as a matter of public policy. Accordingly, the decision below should be reversed.

1. The plain language and structure of SLUSA do not support an exemption for state-law "holder" class actions. The "in connection with" requirement of § 10(b) and Rule 10b-5 is met if the alleged misconduct "coincides" with the purchase or sale of securities. *SEC* v. *Zandford*, 535 U.S. 813 (2002). Applying the same construction to SLUSA means that a class action alleging misconduct in connection with *someone*'s purchase or sale of securities is precluded, even if the plaintiff does not have standing to bring a private Rule 10b-5 action under the rule of *Blue Chip Stamps*. One year before SLUSA was enacted, this Court held that the *Blue Chip Stamps* rule is *not* a substantive restriction on the "in connection with" requirement. *United States* v. *O'Hagan*, 521 U.S. 642 (1997). Congress is presumed to have maintained that distinction in SLUSA.

2. Nor does the legislative history support an exemption for state-law "holder" class actions. Congress understood that SLUSA would preclude some cases that could be brought under state, but not federal law. At the same time, it expressly exempted some traditional state-law remedies, including derivative actions. Congress thus struck a careful balance between private enforcement in federal and state courts. The court below upset that balance by recognizing an extra-statutory exemption for "holder" class actions.

3. There is no sound public policy support for exempting state-law "holder" class actions from SLUSA. Although the legislative history is silent as to "holder" class actions, that silence is explained by the fact that such actions were unknown before SLUSA was enacted. They have proliferated since solely as a means to evade the restrictions of the PSLRA. But the whole point of SLUSA was to stop the "flight" of securities litigation to state court. "Holder" suits

are rife with opportunities for abuse and, if allowed to proceed under state law, would harm issuers and investors alike. And they are unnecessary for investor protection, because purchasers and sellers have sufficient recourse to hold wrongdoers accountable in private Rule 10b-5 litigation (in addition to public enforcement proceedings). Allowing non-transacting "holders" to maintain class actions under state law, in short, would contravene the carefully calibrated scheme of securities enforcement established by Congress in the PSLRA and SLUSA.

ARGUMENT

ICI has a uniquely balanced perspective on the issue in this case, because its members identify with both plaintiffs and defendants in securities fraud lawsuits. Precluding "holder" class actions, as ICI advocates, is entirely consistent with the interests of mutual funds and their investors. Investor protection, which is both the overriding goal of the securities laws and one of ICI's central missions, requires reversal of the decision below.

Mutual funds are significant investors, holding almost one-quarter of all outstanding stock of American public companies, and they and their shareholders have a vested interest in robust enforcement of the securities laws to eradicate securities fraud. ICI's members, therefore, approach this case as potential *plaintiffs* (or class members) in securities fraud actions. "Holder" class actions, however, are not necessary to protect mutual funds or their investors from fraud or deceitful conduct, because federal and state securities laws already provide ample recourse against such unlawful conduct. And such actions are rife with opportunities for abuse, to the detriment of both mutual funds and their investors.

Mutual funds are also significant issuers of securities, with trillions of dollars in shares outstanding, and they are regulated, and subject to liability, under the securities laws. ICI's members are thus also interested in the scope of SLUSA preclusion as potential *defendants* in securities fraud lawsuits. Permitting "holder" class actions could signifi-

cantly harm the interests of mutual funds and their investors. Such actions drive down investment returns by subjecting issuers, including both mutual funds and the companies in which they are invested, to meritless claims that are costly to defend and settle.

In both the PSLRA and SLUSA, Congress struck a careful balance between the interests of investors and the interests of issuers and other market participants. Well-founded private securities litigation may ultimately benefit investors by combating fraud and contributing to good corporate governance, and class action lawsuits can serve as a valuable supplement to public enforcement of the securities laws. H.R. Conf. Rep. No. 104-369, at 31. At the same time, unmeritorious strike suits can adversely impact shareholder returns by forcing companies to spend time and money defending themselves against frivolous claims. *Id.* at 23. In light of such concerns, Congress determined in SLUSA that class actions involving securities fraud should proceed, if at all, in federal court pursuant to the PSLRA, while expressly preserving a number of traditional state-law remedies. H.R. Conf. Rep. No. 105-803, at 13. An additional extra-statutory exemption for state-law "holder" class actions is (1) inconsistent with SLUSA's statutory text and structure; (2) unsupported by its legislative history; and (3) unwarranted and unnecessary as a matter of public policy. Accordingly, the decision below should be reversed.

1. The plain language and structure of SLUSA do not support, much less require, an exemption for state-law "holder" class actions. If alleged misconduct "coincides" with a purchase or sale of securities by someone (including someone other than the plaintiff), then the "in connection with" requirement of Rule 10b-5 is met. *SEC* v. *Zandford*, 535 U.S. 813, 822 (2002). Applying "the normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning" (*Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 570 (1995) (internal quotations omitted)), a lawsuit alleging misconduct that coincides with *someone*'s purchase or sale of securities is pre-

cluded by SLUSA even if the plaintiff does not meet the *Blue Chip Stamps* standing limitation. *Kircher*, 403 F.3d at 484 ("*Blue Chip Stamps* combined with SLUSA may mean that [such claims] must be litigated as derivative actions or committed to public prosecutors, but this is not a good reason to undercut the statutory language"). The contrary conclusion of the court below is irreconcilable with the statutory framework.

The purchaser/seller limitation announced in *Blue Chip Stamps* is a rule of *standing*, not a substantive element of the Rule 10b-5 cause of action. It "does not stem from a construction of the phrase 'in connection with the purchase or sale of any security'" in Rule 10b-5. *Holmes* v. *SIPC*, 503 U.S. 258, 284 (1992) (O'Connor, J., concurring). Rather, it rests on "what may be described as policy considerations," particularly the "danger of vexatiousness" inherent in securities fraud litigation. *Blue Chip Stamps*, 421 U.S. at 737. The Court pointed to two specific dangers: First, even meritless cases have significant settlement value "so long as [the plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment"; and second, the "potential for possible abuse of the liberal discovery provisions" available to plaintiffs. *Id.* at 740-41. To combat these problems, the Court adopted a rule limiting the class of private Rule 10b-5 plaintiffs to those who had actually purchased or sold securities. *Id.* at 754-55.

The *Blue Chip Stamps* Court recognized that its judicially created standing limitation would prevent some private plaintiffs from bringing a Rule 10b-5 action for conduct that met the *statutory* elements of a § 10(b) violation, including the "in connection with" requirement. 421 U.S. at 738; *see also Chiarella* v. *United States*, 445 U.S. 222, 238 n.* (1980 (Stevens, J., concurring) ("the limitation on the right to recover pecuniary damages in a private action identified in *Blue Chip* is not necessarily coextensive with the limits of [Rule 10b-5] itself"). This does not prevent vigorous enforcement of the securities laws, because the SEC and federal

prosecutors can still bring administrative and criminal proceedings against § 10(b) violators.[2]

In *United States* v. *O'Hagan*, 521 U.S. 642 (1997), the Court held unequivocally that the *Blue Chip Stamps* standing limitation does not apply to actions by public officials to enforce § 10(b) and Rule 10b-5. *Id.* at 665 ("Criminal prosecutions do not present the dangers the Court addressed in *Blue Chip Stamps*, so that decision is 'inapplicable' to indictments for violations of § 10(b) and Rule 10b-5") (quoting *Naftalin*, 441 U.S. at 774 n.6). Rather, the statutory "in connection with" element is met if "*someone* buy[s] or sell[s] the security during the period of allegedly fraudulent conduct." Louis Loss & Joel Seligman, *Securities Regulation* 3721 (3d ed. 2004).

The court below "suppose[d] that Congress meant to import the settled [*Blue Chip Stamps*] standing rule along with the 'in connection with' phrase as a substantive standard." Pet. App. 28a. This supposition, however, overlooks the fact that only a year before SLUSA was enacted, this Court had reiterated that the purchaser/seller standing limitation is *not* a substantive aspect of the "in connection with" requirement. *O'Hagan*, 521 U.S. at 665. By expressly incorporating the "in connection with" requirement, but saying nothing of a purchaser/seller limitation, Congress presumably maintained this distinction in SLUSA. *Davis* v. *Mich. Dep't of Treasury*, 489 U.S. 803, 813 (1989) ("When Congress codifies a judicially defined concept, it is presumed, absent an express statement to the contrary, that Congress intended to adopt the interpretation placed on that concept by the courts").

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[2] In 2004 alone, the SEC and state regulators secured roughly $2.5 billion in disgorgement and penalties on behalf of mutual fund shareholders. PricewaterhouseCoopers LLP, *2004 Securities Litigation Study* 18, http://www.10b5.com/-2004_study.pdf.

When Congress wants to adopt a purchaser/seller limitation, it well knows how to do so. *See* Insider Trading & Secs. Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 4680-81 (codified at 15 U.S.C. § 78t-1) (limiting statutory right of action to contemporaneous purchasers and sellers). Congress chose not to in SLUSA, instead adopting language that—as authoritatively construed by this Court—expressly precludes state-law actions alleging misconduct that coincides with *someone's* purchase or sale of securities. *O'Hagan*, 521 U.S. at 658 (parallel language of § 10(b) "requires deception 'in connection with the purchase or sale of any security,' *not* deception of an identifiable purchaser or seller") (emphasis added); *see also Carpenter* v. *United States*, 484 U.S. 19, 24 (1987).

In *O'Hagan*, this Court held that the *Blue Chip Stamps* standing limitation is inapplicable to cases that "do not present the dangers" of vexatious litigation that led the Court to adopt the rule. *O'Hagan*, 521 U.S. at 665. SLUSA preclusion obviously does not present these dangers; to the contrary, SLUSA (like the PSLRA before it) was enacted to address precisely the same evils that animated the *Blue Chip Stamps* policy determination. *See Dura Pharms., Inc.* v. *Broudo*, 125 S. Ct. 1627, 1634 (2005). Accordingly, SLUSA should not be circumvented on the basis of a judicially created rule that was designed to ameliorate, not exacerbate, precisely the same concerns that underlie SLUSA preclusion. *Cf. A.C. Frost & Co.* v. *Coeur d'Alene Mines Corp.*, 312 U.S. 38, 41-43 (1941) (refusing to apply a judicially created rule that would hinder the purpose of the securities laws).

2. The decision below is no more faithful to the legislative history of SLUSA than it is to the statutory text and structure. The court below thought that "Congress sought only to ensure that class actions brought by plaintiffs who satisfy the *Blue Chip* purchaser-seller rule are subject to the federal securities laws." Pet. App. 35a. But if that were the case, one might reasonably expect at least one reference to *Blue Chip Stamps*, or the purchaser/seller standing limitation, in the debates that preceded SLUSA's enactment. But there

is none. It does not appear from the record that *Blue Chip Stamps* was even considered, let alone implicitly codified, by any legislator who voted on SLUSA.

The court below nonetheless read SLUSA's legislative history as "suggesting that Congress understood that it was only preempting claims that could have been brought in federal court to begin with." Pet. App. 32a. But SLUSA's legislative history plainly demonstrates precisely the opposite. Members of both the House and Senate recognized that SLUSA would preclude some class actions that might be permissible under state law but could not be brought by a private plaintiff under federal law for a variety of reasons. *See e.g.*, S. Rep. No. 105-182, at 21-22 (1998) (additional views of Sens. Sarbanes, Bryan & Johnson); 144 Cong. Rec. S. 4778, S. 4786 (1998) (ltr. by B. Roper of the Consumer Fed'n of Am., introduced by Sen. Sarbanes); *id.* at S. 4797-98 (statement of Sen. Johnson); 144 Cong. Rec. H. 6052, H. 6056 (1998) (statement of Rep. Stupak); *see also Testimony of U.S. Secs. & Exch. Comm'n Concerning S. 1260, The "Secs. Litig. Uniform Standards Act of 1997" Before the S. Banking Subcomm.*, 105th Cong. 21 (1997) ("Levitt Testimony"), http://www.sec.gov/news/testimony/testarchive/-1997/tsty1997.txt ("Because a number of states allow claims that cannot be brought under federal law, . . . the bill will preclude relief as a practical matter" for some investors).

For example, "there is no aiding-and-abetting liability in private actions for most federal securities fraud claims." Levitt Testimony at 21; *see Cent. Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). By contrast, "[f]orty-nine states as well as the District of Columbia allow for some form of aiding-and-abetting liability." Levitt Testimony at 21. But a proposed amendment that would have allowed state-law aiding and abetting claims to proceed in federal court was defeated. 144 Cong. Rec. S. 4778, S. 4784 (1998).

Similarly, "private actions under the federal securities laws are subject to a short statute of limitations." Levitt Testimony at 20; *see Lampf, Pleva, Lipkind, Prupis & Petigrow*

v. *Gilbertson*, 501 U.S. 350 (1991) (superseded in part by Pub. L. No. 107-204, Title VIII, § 804(a), 116 Stat. 801 (2002) (codified as amended at 28 U.S.C. § 1658)). "By contrast, 33 states allow for longer limitations periods." Levitt Testimony at 21. Congress rejected a proposed amendment, however, that would have allowed a plaintiff asserting a precluded state law class action to bring a federal claim under the applicable state law statute of limitations. 144 Cong. Rec. at S. 4803.

These two examples show that the court below was simply wrong in concluding that Congress intended SLUSA to preclude only those actions that could be brought under federal law. *Cf.* 144 Cong. Rec. at S. 4805 (statement of Sen. Dodd) (the "purpose of this bill is a uniform standard for . . . nationally traded securities"; "[i]f you are going to apply 50 different statute of limitations you have just destroyed the very purpose of the legislation"). The mere fact that "holder" class actions cannot be brought by private plaintiffs under Rule 10b-5, therefore, does not mean that Congress intended to exempt such actions from SLUSA's preclusive reach. This is confirmed by the fact that Congress considered, and expressly exempted, a number of *other* state-law remedies.

In response to concerns that SLUSA "would eliminate important areas of state corporate law that have long coexisted with—indeed, predate by almost a century—the federal securities laws" (Levitt Testimony at 22), Congress adopted amendments to ensure that certain remedies available under state corporate law would remain available. S. Rep. No. 105-182, at 6. SLUSA exempts actions brought under the law of the State where the issuer is incorporated or organized involving tender offers and communications concerning certain requests for shareholder action (15 U.S.C. §§ 77p(d)(1)(B) & 78bb(f)(3)(A)(ii)), as well as actions under contractual agreements between issuers and indenture trustees (*id.* §§ 77p(d)(3) & 78bb(f)(3)(C)). "These exceptions have become known as the 'Delaware carve-outs.'" *Malone* v. *Brincat*, 722 A.2d 5, 13 (Del. 1998).

In addition to the Delaware carve-outs, SLUSA exempts from its coverage class actions brought by States, political subdivisions, and state pension plans (15 U.S.C. §§ 77p(d)(2) & 78bb(f)(3)(B)), and "exclusively derivative action[s] brought by one or more shareholders on behalf of a corporation" (*id.* §§ 77p(f)(2)(B) & 78bb(f)(5)(C)).[3] SLUSA also limits its class action definition to suits brought on behalf of 50 or more persons, and specifically provides that "a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member." *Id.* §§ 77p(f)(2) & 78bb(f)(5)(B).

The express exemptions that Congress included in SLUSA all contain built-in safeguards against frivolous litigation. For example, derivative litigation requires a threshold showing of merit in order to overcome the demand requirement and judicial scrutiny before settlement. And traditional state corporate law actions must be brought under, and conform to, the law of the state of incorporation. "Holder" class actions, by contrast, have no comparable limitations to protect against abuse; to the contrary, such actions present precisely the dangers that Congress sought to ameliorate by enacting SLUSA and the PSLRA. *See* Joshua D. Ratner, Comment, *Stockholders' Holding Claim Class Actions Under State Law After The Uniform Standards Act of 1998*, 68 U. Chi. L. Rev. 1035, 1058 (2001).

Moreover, the statutory exemptions further demonstrate the careful balance struck by Congress in SLUSA: To ensure

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[3] The statutory exemption for derivative cases is important because most claims brought by non-transacting "holders" are actually derivative in nature. *Schuster* v. *Gardner*, 127 Cal. App. 4th 305 (2005); *Manzo* v. *Rite Aid Corp.*, No. 18451-NC, 2002 Del. Ch. LEXIS 147, *20 (Dec. 19, 2002), *aff'd*, 825 A.2d. 239 (Del. 2003); *Arent* v. *Distrib. Sci., Inc.*, 975 F.2d 1370, 1373 (8th Cir. 1992); *Crocker* v. *FDIC*, 826 F.2d 347 (5th Cir. 1987).

effective enforcement of the securities laws while protecting both companies and investors from abusive litigation, Congress made a series of judgments regarding whether particular claims could be brought in state court or under state law. The court below upset that balance by recognizing an extra-statutory exemption for state-law "holder" class actions. *Cf. Lander* v. *Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 114 (2d Cir. 2001) ("because Congress delineated certain exceptions to the general preemptive force of SLUSA, [federal courts should be] reluctant to impose additional exceptions, particularly when such exceptions are unsupported by the text, history, or purpose of the statute"). Such judicial second-guessing contravenes the congressional intent underlying SLUSA.

3. Just as nothing in the statute or legislative history requires, or even supports, exempting state-law "holder" class actions from SLUSA preclusion, no sound policy basis exists for recognizing such an exemption. In this regard, it is important to note that in *Blue Chip Stamps* this Court was "free to weigh" policy considerations because "[n]o language" in the statute or regulation "speaks at all to the contours of a private cause of action for their violation." 421 U.S. at 749; *see Holmes*, 503 U.S. at 289-90 (Scalia, J., concurring in the judgment) ("the limitation we approved in *Blue Chip Stamps* was essentially a legislative judgment rather than an interpretive one"). By contrast, the Judiciary has no warrant to rely on policy considerations to change or disregard plain statutory language. *See, e.g., CSX Transp., Inc.* v. *Easterwood*, 507 U.S. 658, 664 (1993) ("If the statute contains an express pre-emption clause, the task of statutory construction must in the first instance focus on the plain wording of the clause").

The court below placed great weight on the fact that the legislative history of SLUSA "contains no specific mention of holding claims," perhaps because "Congress may have been unaware of the existence of state law holding claims." Pet. App. 31a-32a (internal quotation omitted). But silence alone is obviously an insufficient basis for inferring a judicial exemption to a statute that, on its face, precludes "holder"

class actions. *See, e.g., Pittston Coal Group* v. *Sebben*, 488 U.S. 105, 115 (1988) ("It is not the law that a statute can have no effects which are not explicitly mentioned in its legislative history"). Even if congressional silence could invite judicial policymaking, however, the policies expressed in the PSLRA and SLUSA provide a clear answer to the question in this case. *See* Pet. App. 29a (recognizing that the persistence of "holder" class actions may undermine the goals of the PSLRA).

Congress's silence on the issue of "holder" class actions is easily explained by the fact that such claims simply were not recognized in any jurisdiction when SLUSA was enacted.[4] A district court subsequently held that securities

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[4] State blue sky laws have always limited relief to transacting shareholders (*see, e.g.*, CCH, Inc., Blue Sky L. Rep. ¶5550 (1997)), and common law "holder" class actions are almost exclusively a post-SLUSA invention. *See WM High Yield Fund* v. *O'Hanlon*, No. 04-3423, 2005 U.S. Dist. LEXIS 12064, *41 (E.D. Pa. May 13, 2005) (noting that no Pennsylvania case had previously addressed the viability of holder claims); *Amzak Corp.* v. *Reliant Energy, Inc.*, No. 03-C0877, 2004 U.S. Dist. LEXIS 16514, *19 n.3 (N.D. Ill. Aug. 18, 2004) (same: Illinois); *Weinstein* v. *Ebbers (In re WorldCom, Inc. Sec. Litig.)*, 336 F. Supp. 2d 310, 319 (S.D.N.Y. 2004) (same: Georgia); *Shirvanian* v. *DeFrates*, No. 14-02-0447-CV, 2004 Tex. App. LEXIS 182, at *47 (Jan. 8, 2004) (same: Texas), *vacated on other grounds*, 161 S.W.3d 102 (Tex. App. 2004); *Rogers* v. *Cisco Sys., Inc.*, 268 F. Supp. 2d 1305, 1312-13 (N.D. Fla. 2003) (same: Florida); *Small* v. *Fritz Cos.*, 30 Cal. 4th 167, 171 (2003) (same: California). The few "holder" class actions that were filed prior to SLUSA were dismissed as meritless. *See Arent*, 975 F.2d 1370; *Crocker*, 826 F.2d 347; *Chanoff* v. *United States Surgical Corp.*, 857 F. Supp. 1011 (D. Conn.), *aff'd*, 33 F.3d 50 (2d Cir. 1994); *Arnlund* v. *Deloitte & Touche LLP*, 199 F. Supp. 2d 461, 486-90 (E.D. Va. 2002). Respondent's reliance on Senator Dodd's statement that SLUSA would pre-

[Footnote continued on next page]

plaintiffs could avoid SLUSA preclusion by suing on behalf of a class of "holders" who could not meet the *Blue Chip Stamps* standing limitation. *Gordon* v. *Buntrock*, No. 00CV303, 2000 U.S. Dist. LEXIS 5977 (N.D. Ill. Apr. 28, 2000). Since then, state-law actions on behalf of "holder" classes have become commonplace. *See* Pet. 17 n.5 (listing cases). Because practically *any* Rule 10b-5 claim can be recast as a "holder" action simply by defining the class to exclude purchasers and sellers, *Gordon* provided a roadmap for securities litigants to evade both SLUSA and the PSLRA.

The whole point of SLUSA was to stop the "flight" of securities litigation to state court as plaintiffs' lawyers sought to avoid the PSLRA. *See* Pet. App. 21a (citing SLUSA § 2, 112 Stat. at 3227). The upsurge in the number of "holder" class actions since SLUSA's enactment plainly reflects continuing "flight." This is particularly troublesome, because "holder" claims present tremendous opportunities for abuse, as recognized by this Court (*Blue Chip Stamps*, 421 U.S. at 734-35, 742) and by those few jurisdictions that have decided to allow them. *See Small* v. *Fritz Cos.*, 30 Cal. 4th 167, 184-85 (2003).[5] Affirmance of the decision below would thus have the perverse effect of allowing the most pernicious category of securities fraud claims to go forward in state

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[Footnote continued from previous page]

serve "traditional state court actions" (Opp. to Pet. for Cert. 13) is thus misplaced: The "holder" class actions at issue here are *not* "traditional" state court actions by any stretch.

[5] SLUSA should not be construed to allow States to recognize *new* class action remedies on behalf of "holders" that would allow securities litigants to avoid the strictures of the PSLRA. Indeed, one of the primary motivations for SLUSA was a post-PSLRA California ballot initiative that would have dramatically expanded the state-law remedies for securities fraud. *See* Timothy J. Burger, *New Securities Reform Fight Looms*, The Recorder, Apr. 16, 1997, at 1.

court, free of the PSLRA's protections against abusive litigation—including provisions designed to prevent the exploitation of absent class members. *See* 15 U.S.C. §§ 77z-1(a) & 78u-4(a). Such suits would continue to be filed in "lottery" jurisdictions across the country, leading to *in terrorem* settlements as issuers and other market participants seek to avoid the costs of defense and the risk that "a local judge or jury may produce an idiosyncratic award." *Kircher*, 403 F.3d at 484.

Almost by definition, mutual fund investors are "holders" of securities. Approximately 92 percent of fund shareholders are saving for retirement. *2005 Investment Company Fact Book* 30. "Most shareholders have invested in mutual funds for many years; 70 percent have owned funds for at least 10 years." *Id.* at 31. More than 80 percent of mutual fund investors make *no* sales from their portfolios in a given year. *See* ICI, *Facts About Funds: A Guide To Investment Company Research About Mutual Funds & Mutual Fund Shareholders*, at 4 (2004), http://www.ici.org-/pdf/bro_factsaboutfunds.pdf. And although periodic purchases by mutual fund investors are common (through retirement contributions or dividend reinvestment, for example), a class can be defined to exclude such purchases. Thus, if "holder" class actions are allowed to proceed under state law, state-law claims could be asserted against mutual funds and their affiliates in virtually any circumstance.

While state-law "holder" class actions pose a very real threat to mutual funds and other issuers (and, ultimately, their shareholders), such lawsuits are not necessary to protect mutual fund shareholders or other investors. ICI's members, with over $8 trillion under management, have seen firsthand the problems for investors caused by abusive class action litigation. ICI supported both the PSLRA and SLUSA because those statutes promote vigorous enforcement of the securities laws while deterring strike suits that serve merely to enrich a few while diluting the returns of ordinary investors. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 32 ("When an issuer must pay lawyers' fees, make settlement payments, and

expend management and employee resources in defending a meritless suit, the issuers' own investors suffer").

"Holder" class actions are not necessary to combat securities fraud because purchasers and sellers have sufficient recourse to hold wrongdoers accountable in private Rule 10b-5 litigation (in addition to public enforcement proceedings). Yet "holder" class actions, while unnecessary, carry enormous potential for abuse—to the detriment of issuers and investors alike. Long-term, buy-and-hold investors favor good corporate governance, predictable regulation, and effective enforcement; but they have no interest in "get rich quick" litigation, which benefits only "those who seek to line their own pockets by bringing abusive and meritless suits." H.R. Rep. No. 104-369, at 31-32. The decision below, if allowed to stand, would only encourage the proliferation of such suits, to the detriment of the investing public.

Congress has already made the *policy* determination in SLUSA that the interests of investors in the national securities markets are generally served by uniform, national standards for class action litigation; at the same time, Congress recognized the importance of certain state law remedies (in addition to public enforcement actions) and drew careful, express exemptions to safeguard them. Allowing non-transacting "holders" of securities to maintain class actions under state law cannot be squared with that carefully calibrated regime. The court below exceeded the proper judicial role in crafting an additional exemption to SLUSA preclusion for state-law "holder" class actions—an exemption that is not supported by the statutory text, its legislative history, or sound public policy. Unless corrected by this Court, America's investors will pay the price for that mistake.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF *AMICI CURIAE* LORD, ABBETT & CO. AND EATON VANCE MANAGEMENT IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*[1]

Amicus Curiae Lord, Abbett & Co. LLC ("Lord Abbett") is a Delaware limited liability company, and *Amicus Curiae* Eaton Vance Management ("Eaton Vance") is a Massachusetts business trust. Both are investment advisers registered under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1, *et seq.* Lord Abbett manages one of the nation's oldest mutual fund complexes. Eaton Vance has been managing assets since 1924 and mutual funds since 1931. The mutual funds managed by *amici curiae* are investment companies registered under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq.* Shares of registered investment companies are "covered securities" within the meaning of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA"). *See* 15 U.S.C. §§ 77p(f)(3), 78bb(f)(5)(E).

Amici curiae have a substantial interest in the issue discussed in this brief because it is relevant to pending cases in which they are defendants. *In re Lord Abbett Mutual Funds Fee Litig.*, No. 04-cv-559 (D.N.J. filed Feb. 9, 2004), 385 F. Supp. 2d 471 (D.N.J. 2005) (dismissing complaint based on SLUSA and other grounds, but allowing plaintiffs a limited opportunity to replead); *In re Eaton Vance Mutual Funds Fee Litig.*, No. 04-cv-1144 (S.D.N.Y. filed Feb. 11, 2004), 380 F. Supp. 2d 222 (S.D.N.Y. 2005) (dismissing action based on SLUSA and other grounds).

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1. Pursuant to Supreme Court Rule 37.6, *amici curiae* state that counsel for *amici* authored this brief in its entirety. No person or entity other than *amici*, their counsel, or their insurer made a monetary contribution to its preparation or submission. Letters of consent from both parties have been filed with the Clerk of the Court pursuant to Supreme Court Rule 37.3.

SUMMARY OF THE ARGUMENT

The court in *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005), committed not one but two fundamental errors in construing SLUSA.

One of the mistakes the Second Circuit made has been raised by petitioners: the court incorrectly held that SLUSA does not preempt state law class action claims based upon allegedly fraudulent statements or omissions brought solely on behalf of persons who were induced thereby to hold or retain (and not purchase or sell) securities (sometimes referred to as "holders" claims). The *amici* will not repeat petitioners' analysis.

The court below also committed a second, logically antecedent error that is addressed in this brief. To enable it to reach the issue of whether SLUSA preempts holders claims, the Second Circuit brushed aside the statutory language requiring that, if a complaint contains one or more SLUSA-preempted claims (which the Second Circuit held that the complaints at issue did, *Dabit*, 395 F.3d at 47-49), the action must be dismissed in its entirety. *Dabit*, 395 F.3d at 47. As the Third Circuit has recognized, SLUSA "does not preempt particular 'claims' or 'counts' but rather preempts 'actions,' 15 U.S.C. § 78bb(f)(1), suggesting that if any claims alleged in a covered class action are preempted, the entire action must be dismissed." *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 305 (3d Cir. 2005).

The Second Circuit offered three reasons for declining to apply the statute as written: (1) that "the historic police powers of the states are not preempted unless it was Congress's clear and manifest purpose to do so," (2) that a

literal interpretation would mean that SLUSA is an "imprecise instrument," and (3) that the legislative history of SLUSA "indicate[s] no intent to preempt categories of state action that do not represent 'federal flight' litigation." *Dabit*, 395 F.3d at 47 (citation and internal quotation marks omitted). These are inadequate bases to depart from the statutory language. That language is more than sufficiently clear to overcome whatever presumption of preemption may apply in this context; construing the statute in a way that arguably makes it an "imprecise instrument" hardly leads to the type of absurd results that justify deviating from the statutory text; and there is no need to look to legislative history to confirm that the statute means what it says.

While it may not be necessary for the Court to issue a definitive ruling on the issue discussed herein in order to reverse the judgment below, the *amici* respectfully urge the Court at a minimum both to avoid implicitly endorsing *Dabit's* erroneous reading of the statute and to identify the issue as one that remains to be decided. Because a number of lower courts have overlooked this issue, the *amici* believe this is an instance where an "unexamined assumption[] . . . [may] becom[e], by force of usage, unsound law." *McCormick v. United States*, 500 U.S. 257, 280 (1991) (Scalia, J., concurring).

ARGUMENT [2]

The Second Circuit correctly concluded that at least some of the claims raised in each of the two actions at issue in *Dabit* were preempted by SLUSA. *See Dabit*, 395 F.3d at 47 (claims of plaintiff Dabit and the putative class for damages resulting from the owning and retention of certain stocks were preempted and dismissed without prejudice); *id.* at 48 (claims of plaintiff IJG and the putative class for commissions paid to Merrill Lynch were preempted).

That conclusion should have resolved the case. The statutory text of SLUSA mandates that, when a covered class action based upon state law includes allegations of a misrepresentation or omission of a material fact in connection with the purchase or sale, the entire action must be dismissed. As the Court of Appeals for the Third Circuit has recently explained:

> Under the statutory language, inclusion of these preempted claims within the putative class compels dismissal of the entire action. 15 U.S.C.

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2. The *amici* recognize that, at first blush, the discussion herein may appear to be outside the ambit of the question presented. As this Court has recently stated, however, "[q]uestions not explicitly mentioned but essential to analysis of the decisions below or to the correct disposition of the other issues have been treated as subsidiary issues fairly comprised by the question presented." *Ballard v. Comm'r*, 125 S. Ct. 1270, 1275 n.2 (2005) (citations and internal quotation marks omitted); *see also id.* (it is appropriate to address an issue that is anterior to the specific question presented). At a minimum, the *amici* wish to avoid the possibility of this Court implicitly endorsing what the *amici* believe to be an erroneous interpretation of the statute in the course of addressing the explicit question presented.

> § 78bb(f)(1) (requiring dismissal of any covered "action" alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security").

Rowinski, 398 F.3d at 304. Stated another way:

> [SLUSA] does not preempt particular "claims" or "counts" but rather preempts "actions," 15 U.S.C. § 78bb(f)(1), suggesting that if any claims alleged in a covered class action are preempted, the entire action must be dismissed.

Id. at 305.[3] Accordingly, because as the Second Circuit correctly held, at least some "counts" of the complaints at issue in *Dabit* were preempted by SLUSA, the ***entire action*** should have been dismissed.[4]

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3. *See also* 15 U.S.C. § 78bb(f)(2) (providing for removal of covered "action"); 15 U.S.C. § 78bb(f)(5)(C) (recognizing exception to definition of "covered class action" for "an ***exclusively*** derivative action") (emphasis added). The prohibition against the "maint[enance]" of covered actions, § 78bb(f)(1), manifestly requires dismissal of such actions; merely declaring certain claims preempted but still permitting a plaintiff to continue with the action is precisely what the statute forbids. *See, e.g., Riley v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 292 F.3d 1334, 1341 (11th Cir. 2002) (in SLUSA, "Congress . . . require[ed] the immediate dismissal of 'covered lawsuits'"); *Smallwood v. Gallardo*, 275 U.S. 56, 61 (1927) ("To maintain a suit is to uphold, continue on foot and keep from collapse a suit already begun." Maintaining a suit also includes commencing a new suit "at a later day.").

4. *See generally American Nat. Bank and Trust Co. of Chicago v. Equitable Life Assurance Soc'y*, 406 F.3d 867, 874-75 (7th Cir.

(Cont'd)

The Third Circuit's straightforward understanding of the equally straightforward statutory language comports with decisions by this Court and the Courts of Appeal recognizing that congressional use of the term "action" in generally similar contexts is a deliberate policy choice that courts are not free to disregard. In *Chicago v. International College of Surgeons*, 522 U.S. 156 (1997), for example, the Court wrote:

> [The] federal claims suffice to make the actions "civil actions" within the "original jurisdiction" of the district courts for purposes of removal.... Nothing in the jurisdictional statutes suggests that the presence of related state law claims somehow alters the fact that [the] complaints, by virtue of their federal claims, were "civil actions" within the federal courts' "original jurisdiction."

Id. at 166 (citation and internal quotation marks omitted). *See also Spring Garden Associates, L.P. v. Resolution Trust Corp.*, 26 F.3d 412, 415-16 (3d Cir. 1994) (The phrase "any action" in a removal statute differs significantly from "any claim." The "commonly understood meaning" of "any action . . . encompasses the entirety of a[] case . . . and not just [certain] claims."); *Dillon v. State of Miss. Military Dept.*, 23 F.3d 915, 918-19 (5th Cir. 1994) (court held that it is clear that the scope of removal pursuant to 28 U.S.C. § 2679(d)(2) encompasses the entire action given the "plain

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(Cont'd)

2005) ("unlike the dismissal of the complaint, which can ordinarily be amended, the dismissal of the entire action ends the litigation . . . whether the suit is dismissed with prejudice or without prejudice") (citations and internal quotation marks omitted); *United States v. Wallace & Tiernan Co., Inc.*, 336 U.S. 793, 794 n.1 (1949).

language" of the statute: "[t]he statute states that the 'action or proceeding . . . shall be removed'. 28 U.S.C. § 2679(d)(2). It does not speak of claims or federally linked defendants; it speaks of the entire action.") (footnotes omitted).

Despite the clear statutory language in this respect, a number of courts appear simply to have assumed that it is appropriate to conduct a claim-by-claim analysis and have failed to apply SLUSA's language mandating removal and preemption of actions as a whole. Indeed, one district court in 2003 stated that a Ninth Circuit decision, *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1131 (9th Cir. 2002), which did not address the issue discussed herein, "is illustrative of the uniform approach taken by the courts in segregating claims that are preempted by SLUSA from pure state law claims that are not, thus rejecting [defendant's] argument that SLUSA applies to 'actions' and not to claims." *Cape Ann Investors LLC v. Lepone*, 296 F. Supp. 2d 4, 13 n.7 (D. Mass. 2003).[5]

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5. For other cases in which courts conducted a claim-by-claim analysis, *see, e.g., Professional Management Associates, Inc. v. KPMG LLP*, 335 F.3d 800 (8th Cir. 2003) (assuming without discussion that claim-by-claim analysis applies); *Gray v. Seaboard Secs., Inc.*, 241 F. Supp. 2d 213, 219-22 (N.D.N.Y. 2003) (court determined SLUSA preemption as to each claim), *rev'd*, 126 Fed. Appx. 14 (2d Cir. 2005) (affirming the claim-by-claim approach but reversing on other grounds); *Vohs v. Miller*, 323 F. Supp. 2d 965, 973-74 (D. Minn. 2004) (plaintiff's complaint alleged both federal claims and state law claims for fraudulent misrepresentation and civil conspiracy; the court determined SLUSA preemption separately as to plaintiff's state law claims). *But cf. Miller v. Nationwide Life Insurance Co.*, 391 F.3d 698, 702 n.2 (5th Cir. 2004) (The court noted that the defendant "suggests that these [preemption-triggering] allegations, made within the overall complaint, but outside the state

(Cont'd)

In this case, the Second Circuit acknowledged the relevant statutory language. It recognized that:

> SLUSA prohibits the "maint[enance] in any State or Federal court" of any "covered class action" alleging fraud in the purchase or sale of a covered security under state law, 15 U.S.C. § 78bb(f)(1), and defines a "covered class action" as a "single lawsuit" or "group of lawsuits" brought on behalf of more than fifty persons and meeting other specified criteria, 15 U.S.C. § 78bb(f)(5)(B). These provisions might be read to suggest that where a single complaint contains claims that include allegations triggering preemption and other claims that do not, SLUSA prohibits maintenance of the entire action.

Dabit, 395 F.3d at 47.

This understanding of the language of the statute is clearly correct, but the Second Circuit declined to apply the statute literally. *Dabit*, 395 F.3d at 47. The Second Circuit provided three reasons for doing so, none of which warrant deviating from the natural meaning of the statutory text.

The court first observed that "the historic police powers of the states are not to be preempted unless it was Congress's 'clear and manifest purpose' to do so." *Dabit*, 395 F.3d at 47, *quoting City of Milwaukee v. Illinois*, 451 U.S. 304, 316

(Cont'd)

law claim, are sufficient to require dismissal under SLUSA." It declined to decide the issue because plaintiff's "state law claim itself contains allegations of misrepresentation and/or omissions.").

(1981). Here, however, there is only one plausible reading of the statute at issue – indeed, the court below did not articulate *any* alternative interpretation of SLUSA's text – and Congress's purpose therefore is "clear and manifest." *See Bates v. Dow Agrosciences LLC*, 125 S. Ct. 1788, 1801 (2005).[6]

The Second Circuit next indicated that it would refuse to interpret the text of SLUSA in accordance with its ordinary meaning because to do so would, in that court's view, mean that SLUSA is "an imprecise instrument." *Dabit*, 395 F.3d at 47. The relevance of the Second Circuit's statement in this regard is unclear. Statutes must be applied in accordance with their terms whether or not they are "imprecise instruments." Indeed, statutes often cover situations other than those that may have primarily motivated their drafters. *See Brogan v. United States*, 522 U.S. 398, 403 (1998) ("it is not, and cannot be, our practice to restrict the unqualified language of a statute to the particular evil that Congress was trying to remedy – even assuming that it is

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6. It is doubtful, moreover, that the premises underlying the Second Circuit's invocation of a presumption against preemption are valid. For example, it does not appear that nationally traded securities are properly considered "areas of traditional state regulation," *id.*, in light of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), SLUSA, and the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in part at 15 U.S.C. § 77r), which preempted large swaths of state regulation in this area. *Cf. Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 111 (2d Cir. 2001) (these three statutes "considered in concert . . . demonstrate that Congress intended to provide national, uniform standards for the securities markets and nationally marketed securities.").

possible to identify that evil from something other than the text of the statute itself.").

To the extent that the Second Circuit's statement might be construed as a policy argument against a literal application of the statute, the statement is both dubious and irrelevant. It is dubious because requiring dismissal of the entire action will help to deter the filing of speculative SLUSA-preempted claims and is entirely consonant with the clear congressional purpose of eradicating abusive tactics and overreaching by the securities class action plaintiffs' bar. It is irrelevant because "[c]ourts may not create their own limitations on legislation, no matter how alluring the policy arguments for doing so." *Brogan*, 522 U.S. at 408. *See also Central Bank v. First Interstate Bank*, 511 U.S. 164, 188 (1994) ("policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result so bizarre that Congress could not have intended it.") (citations and internal quotation marks omitted).

Finally, the Second Circuit attempted to buttress its conclusion by stating that "SLUSA's language and legislative history indicate no intent to preempt categories of state action that do not represent 'federal flight' litigation." *Dabit*, 395 F.3d at 47. As already discussed (and as the Second Circuit itself all but conceded), the statutory language is clear. As for the Second Circuit's insistence on legislative history to confirm what the statute clearly says: "it would be a strange canon of statutory construction that would require Congress to state in committee reports or elsewhere in its deliberations that which is obvious on the face of a statute." *Harrison v. PPG Industries, Inc.*, 446 U.S. 578, 592 (1980). *See also Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 386 n.2

(1992) ("[L]egislative history need not confirm the details of changes in the law effected by statutory language before we will interpret that language according to its natural meaning"); *Exxon Mobil Corp. v. Allapattah Services, Inc.*, 125 S. Ct. 2611, 2625-27 (2005). Even if it were appropriate to consult legislative history, that history affirmatively supports an expansive reading of SLUSA. *See Rowinski*, 398 F.3d at 299 (legislative history indicates that Congress "envisioned a broad interpretation of SLUSA").

CONCLUSION

For the foregoing reasons, the *amici curiae* respectfully submit that the statutory language of SLUSA mandates that, when a complaint contains one or more SLUSA-preempted claims, the action must be dismissed in its entirety. Accordingly, the *amici curiae* urge the Court to reverse the judgment below on this basis or, in the alternative, to (1) specifically note the issue for further consideration by the lower courts, or (2) at least avoid any implicit endorsement of the Second Circuit's erroneous conclusion to the contrary.

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On Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF OF NATIONAL ASSOCIATION OF SHAREHOLDER AND CONSUMER ATTORNEYS AND AARP AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*[1]

The National Association of Shareholder and Consumer Attorneys ("NASCAT") is a nonprofit membership organization founded in 1989. The member law firms represent investors (both individuals and institutions) in securities fraud and shareholder derivative cases in federal and state courts throughout the United States. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes, and so-called "white-collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior, and improving access to justice and compensation for the wrongs inflicted upon victims. NASCAT advocates the principled interpretation and application of state and federal securities laws – including the Securities Act of 1933 (the "1933 Act"), Securities Exchange Act of 1934 ("1934 Act"), Private Securities Litigation Reform Act of 1995 (the "PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (1995) and Securities Litigation Uniform Standards Act ("SLUSA") – to protect investors from manipulative, deceptive and fraudulent practices and to ensure that the nation's securities markets operate fairly and efficiently.

AARP is a non-profit, non-partisan organization with more than 35 million members, dedicated to addressing the needs and interests of Americans aged 50 and older. As

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[1] Pursuant to Rule 37.6, counsel for NASCAT and AARP represent that they authored this brief in whole and that no person other than the *amici curiae*, their members or their counsel made a monetary contribution to the preparation or submission of the brief. Consent to the filing of *amici* briefs in support of either party was received by the Court from counsel for Respondent October 17, 2005 and from counsel for the Petitioner October 18, 2005.

the largest membership organization representing the interests of older Americans, AARP is very concerned about fraudulent practices in the securities industry. Older people are frequent targets of fraud because they often have significant assets and are looking for investment opportunities that will supplement the Social Security and pension benefits they hope to receive during retirement. As a result, AARP has made the need to combat securities fraud a high priority, and advocates the availability and enforcement of adequate federal and state statutory remedies to provide victims with financial redress.

NASCAT and AARP have regularly commented on legislative and regulatory proposals that address investment fraud, have filed *amicus curiae* briefs in cases involving interpretation of the federal securities laws, including *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), *SEC v. Edwards*, 540 U.S. 389 (2004), and *SEC v. Zandford*, 535 U.S. 813 (2002), and have opposed efforts to limit federal statutory remedies that allow defrauded investors to obtain financial redress.

In this case, NASCAT and AARP believe that the Second Circuit correctly held that SLUSA does not preempt securities "holder claims" and that this Court's affirmance of that ruling will further the goal of protecting victims of investment fraud and help ensure that they can obtain recovery for their losses. A contrary ruling will foreclose most avenues of redress for many investors, particularly older persons, who tend to hold their investments for long-term appreciation and would not have viable purchase/sale claims under the 1933 Act, the 1934 Act and/or the PSLRA. These investors may sustain losses due to a scheme to defraud that have a significant impact on their retirement savings, yet are too small to justify the

expense of an individual lawsuit. They will have no recourse if this Court finds that SLUSA preempts state law class actions.

SUMMARY OF ARGUMENT

In this case the Second Circuit has most capably set forth why, as a matter of simple and straightforward statutory construction, the provisions of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), 15 U.S.C. §§ 77p and 78bb(f), do not preempt state law based class actions that are brought on behalf of shareholders whose claims do not arise out of fraud in connection with the purchase or sale of a covered security. The Seventh Circuit's opaque and convoluted reasoning in *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. Ill. 2005), *reh'g denied* (May 2, 2005), *petition for cert. filed*, (Sept. 29, 2005), stands in stark contrast: simply stated, *Kircher* stands the principles of statutory construction on their proverbial head. A comparison of these two recent circuit court opinions does more to advance Respondents' position than anything else.

Rather than attempt to repeat the already well-wrought rationale of the Second Circuit, in this *amici* brief NASCAT and AARP will first focus on an aspect that is essential to any determination of SLUSA preemption in this matter: What precisely is a "holder" claim? Before one can reach any conclusions about "holder" class actions and whether all or any should be preempted by SLUSA, there must be an understanding – a common ground – as to what precisely is the nature and legal basis of a true state law holder claim.

Without taking into consideration whether or not "holder" claims can be certified as a class action, either under Fed. R. Civ. P. 23 or its state law equivalent(s), or whether such claims brought as a class action might be subject to SLUSA preemption, the *bona fides* of such a claim, as a matter of common law, are manifest – as discussed below, they are straightforward common law fraud claims asserting that the frauds induced the continual holding of the subject security.

Most important, these are not Section 10(b) "purchaser" actions and thus, since this Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), have clearly not been within the ambit of Section 10(b) of the 1934 Act. As set forth more fully below, the legal viability of such claims as individual actions and whether such claims should be allowed to proceed as class actions should be left to the state courts, particularly since such claims were not within Congress's collective mind – let alone an express subject of SLUSA. *See City of Milwaukee v. Illinois*, 451 U.S. 304, 316 (1981) ("in deciding if federal law preempts state law ... we start with the assumption that historic police powers of the state were not to be superceded by the Federal Act unless that was the clear and manifest purpose of Congress").

I. Holder Claims Defined

Assume a shareholder purchased a stock January 1, 1994. Assume also that the issuing company first began engaging in fraudulent manipulation of its financial reporting February 1, 1994, and continued to do so until the truth became public January 3, 1997. The shareholder received, reviewed and relied upon each of the company's

annual reports for years 1994, 1995, and 1996 all of which contained the false and misleading financial information. These annual reports, in turn, induced the shareholder to continue to hold on to his or her stock. In January 1997, when the truth about the company is disclosed, the stock precipitously drops in value, and the shareholder experiences a corresponding loss as a result of his or her continuing to hold the stock in reliance upon these false financial representations. There can be no doubt that the shareholder experienced a loss as result of his or her reliance upon the fraudulent financial representations – the day before the disclosure of the truth he or she had holdings that were valued at $X and the day after the truth was disclosed the holdings were diminished to $X-T (where T equals the market adjusted value of the stock after taking into account the impact of the truth).[2]

Such facts state a *prima facie* claim for common law fraud. Misrepresentations, reliance, action taken in reliance upon the misrepresentations, injury and damage – a paradigm common law fraud claim. Moreover, by definition it is an action that is not seeking damages arising out of frauds made in connection with the purchase or sale of a security.

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[2] The above fact pattern is similar to one that occurred with Mercury Finance Company, a Wall Street darling stock that reported 48 quarters of ever increasing profits only to restate 3 years of financial reporting to reflect that it had, in fact, been losing money throughout those years. A holder action brought in that matter has been certified as a class action and, in fact, is an example of how such an action can be certified as a class and achieve procedural efficiencies for state courts while providing justice for defrauded shareholders. *See, Dloogatch v. Brincat*, 97CH8790, Circuit Court of Cook County, Illinois, Chancery Division, July 31, 2003 Memorandum Opinion and Order, Appendix at App. 1.

There is nothing novel or cutting edge about such a claim. Simply stated, a "holder" claim is a straightforward state law common law fraud or misrepresentation claim. It is brought on behalf of a shareholder who has been defrauded into ***retaining*** (as opposed to purchasing or selling) a security. It does not seek damages arising out of frauds perpetrated in connection with the purchase or sale of securities. Rather, the gravamen of the claim is that at some point in time after the shareholder acquired the securities in question, the shareholder was fraudulently induced to continue to hold the subject securities until such time as the truth became public. This is the paradigm "holder" claim.

Moreover, contrary to what some counsel and courts have assumed, a "holder" claim does not require proof of whether a shareholder was induced to refrain from selling his or her stock at some point in time. It is this phantom element that has given some courts and commentators pause. They posit that it will open up the possibility of manufactured intentions to sell. As a threshold matter, the possibility of manufactured testimony with respect to the intent to sell is no basis to extinguish an entire cause of action. Numerous civil disputes revolve around proof of a person's intent and in turn the proof is based upon oral testimony regarding the witness' intent. Countless defendants accused of fraud have testified that they did not intend to commit fraud only to be found liable for fraud.

Most important, however, is that proof of intention to sell at some prior point in time, while certainly an option, is not a required element of a "holder" claim. Rather, the

claim is a typical common law claim alleging that defendant's misrepresentations and plaintiff's reliance on same induced plaintiff to take an affirmative act – that of continuing to hold on to the subject securities, until the truth was disclosed and as a result plaintiff was damaged when the disclosure of the truth caused the stock to drop in value.

Likewise, as this Court may have already seen in its review of the most recent lower court decisions dealing with "holder" claims, there is some confusion both within the bar and the bench as to what is a "holder" claim. Section 10(b) claimants purchased their securities and then continued to hold them until the fraud was disclosed. As a result, some cases, which are really purchaser fraud actions, have been pled as "holder" claims on behalf of shareholders who purchased their stock when the frauds were occurring and thus could have brought timely federal securities fraud actions.

NASCAT and AARP respectfully submit that such class actions are preempted by SLUSA and we have no problem with the proposition that SLUSA preempts state law based class actions on behalf of persons who purchased their securities within three years of the disclosure of the fraud, whether the case is styled as a holder/purchaser action or as a holder action. Such persons had valid Section 10(b) claims and were precisely the sort of state law class actions that Congress intended to prohibit and thus preempt: State law class actions brought on behalf of classes that include persons who had valid purchaser or seller claims under Section 10(b) of the 1934 Act.

There is a "hybrid" action, when purchaser claimants and holder claimants are lumped into one class of state law fraud claimants, which should also be preempted under SLUSA to the extent that plaintiffs insert or include purchaser claims in the class. Where, however, a class action is brought on behalf of investors who acquired their securities before the commencement of the actionable Section 10(b) fraud,[3] and the action is strictly limited to claims for damages arising from these investors being fraudulently induced to continue to hold on to their securities, such an action is not and should not be preempted under SLUSA. *See, e.g., Gordon v. Buntrock*, 2000 WL 556763,*4 (N.D. Ill. April 28, 2000).

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[3] The Second Circuit appears to hold that only "holder" claimants who acquired their shares prior to the commencement of the scheme to defraud can avoid the reach of SLUSA. In its view, if one bringing a "holder" claim purchased the security in question at a time when the frauds were alleged to have been occurring, even though it was over three years prior to the discovery of the fraud, any such claims brought as a class action should be preempted under SLUSA. NASCAT and AARP respectfully submit that this is the only error in the Second Circuit's approach. As discussed in greater detail below, SLUSA was intended to bar class action claims that could have been brought in federal court from being brought in state courts. If a defrauded investor has a potential Section 10(b) claim that is barred due to the three-year statute of limitations, this should not preclude her from pursuing, on a class basis, a separate and independent holder claim. The two claims are entirely distinct; indeed, they have entirely different elements and involve entirely different damages. In fact, it would work a severe injustice if investors who were the victims of a fraud that spanned five years were barred from seeking any recovery whatever merely because the perpetrators of the fraud were able to cover their tracks for a period beyond the three-year federal statute of limitations. Again, in the absence of Congress's clearly expressed intention that such claims should be preempted, it is respectfully submitted that these claims are not within the ambit of SLUSA.

II. History of Holder Claims

A. Pre 1933 and 1934 Acts

The states traditionally regulated securities fraud through common law torts such as fraud and negligent misrepresentation, stockholder derivative suits, and blue sky legislation. *See* Joshua D. Ratner, *Stockholders' Holding Claim Class Actions Under State Law After the Uniform Standards Act of 1998*, 68 U. Chi. L. Rev. 1035, 1037 (2001) (hereinafter, "Ratner *Stockholders' Holding Claims*"). From early on, most states that considered the issue recognized "holder claims" – *i.e.*, claims based on allegations that misrepresentations induced forbearance from selling stock. *See, e.g., David v. Belmont,* 291 Mass. 450, 197 N.E. 83 (1935) (alleging fraud inducing retention of stock shareholder would otherwise have sold); *Fottler v. Moseley,* 179 Mass. 295, 60 N.E. 788 (1901) (holding plaintiff stated claim for fraud against broker whose misrepresentations induced him to refrain from selling stock); *Duffy v. Smith,* 28 Vroom 679, 57 N.J.L. 679, 32 A. 371 (1895) (plaintiff fraudulently induced to buy stock could recover for period of retaining stock in reliance on same misrepresentation); *Continental Insurance Co. v. Mercadante*, 222 A.D. 181, 183-84, 225 N.Y.S. 488, 490-91 (1927) (considering claim for "fraud in inducing, not purchase of the bonds, but their retention after purchase," and holding that "plaintiffs cannot be denied redress because their conduct was inaction, rather than action").[4] *See also, Rothmiller v. Stein*, 98 Sickels 581, 38 N.E. 718,

[4] It should also be noted that what might be perceived as inaction (*e.g.*, not selling the stock) is actually an affirmative act that has been induced by the fraud – that act being the continued holding and retention of the stock.

719 (N.Y. 1894) (rejecting argument that plaintiff failed to state a claim based on allegations that he refrained from selling his stock based on defendant's misrepresentations); *Gutman v. Howard Savings Bank*, 748 F. Supp. 254, 264 (D.N.J. 1990) (holding that inaction induced by defendants' representations can establish the element of reliance in a common law securities fraud claim); *see also Small v. Fritz Companies, Inc.*, 30 Cal. 4th 167, 132 Cal. Rptr. 2d 490, 65 P.3d 1255 (2003).

Congress enacted the first federal laws regulating securities in the early 1930's in response to the stock market crash of 1929. *See* Ratner, *Stockholders' Holding Claim*, 68 Chi. L. Rev. at 1042. Congress passed the 1933 Act and the 1934 Act because the states had been ineffective in regulating nationally traded securities. *Id.* at 1042 (citing Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1, 24-25 (1998) (hereinafter Painter, *Responding to a False Alarm*) (noting that states were ineffective as the sole regulators of nationally traded securities because of state securities commissioners' inability to extend their authority across state lines). Despite Congress' concerns, each Act explicitly allowed concurrent securities regulation by the states. *See* Ratner, *Stockholders' Holding Claim*, (citing Painter, *Responding to a False Alarm*, 84 Cornell L. Rev. at 24-25 (noting that Section 18 of the 1933 Act did not affect the jurisdiction of state securities commissions and bestowed concurrent state and federal court jurisdiction and that while the 1934 Act gave federal courts exclusive jurisdiction over claims under that statute, Section 28(a) specifically protected blue sky laws from federal preemption). *See also* 15 U.S.C. § 77r (1933 Act's provision granting concurrent

jurisdiction); 15 U.S.C. § 78bb(a) (1934 Act's provision granting concurrent jurisdiction).

Section 10(b) of the 1934 Act enabled the SEC to enact rules and regulations regarding the use of manipulative and deceptive devices in relation to the purchase or sale of securities. 15 U.S.C. § 78j(b); *see Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988). Among other things, the 1934 Act included extensive disclosure requirements. *Basic*, 485 U.S. at 230. Under the authority granted by the 1934 Act, in 1942 the SEC promulgated a regulation making it

> unlawful for any person . . . (a) [t]o employ any device, scheme or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, . . . not misleading, or (c) [t]o engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the *purchase or sale* of any security.

17 C.F.R. § 240.10b-5 (emphasis added).

Following the enactment of the 1933 and 1934 Acts, it became apparent that private suits were important to supplement government enforcement actions. Ratner, *Stockholders' Holding Claims*, 68 U. Chi. L. Rev. at 1043. In response to this acknowledged need, the lower federal courts found an implied (or inferred a) private right of action to enforce Section 10(b) of the 1934 Act and SEC Rule 10b-5, and this Court endorsed this view in 1988. Ratner, *Stockholders' Holding Claim*, 68 U. Chi. L. Rev. at 1043; *Basic*, 485 U.S. at 230-31. In *Birnbaum v. Newport*

Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952), the Second Circuit interpreted SEC Rule 10b-5 as aimed only at "'a fraud perpetrated upon the purchaser or seller' of securities and as having no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers." The *Birnbaum* court's interpretation of Rule 10b-5 barred holder's actions under that rule.

In 1975, this Court agreed that Rule 10b-5 did not permit holder actions. *Blue Chip Stamps*, 421 U.S. at 733, 749. This Court recognized, however, that completely barring holders' actions would result in injustice by denying relief to victims of fraud. The Court concluded that because its decision was limited to actions under Rule 10b-5, such injustice would not occur because defrauded stockholders still have a remedy in state court. As this Court stated:

> A great majority of the many commentators on the issue before us have taken the view that the *Birnbaum* limitation on the plaintiff class in a Rule 10b-5 action for damages is an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5. . . . We have no doubt that this is indeed a disadvantage of the *Birnbaum* rule, and if it had no countervailing advantages it would be undesirable as a matter of policy. . . .

Blue Chip Stamps, 421 U.S. at 738-39. This Court further observed:

> Obviously this disadvantage is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law. *Cf.* § 28

> of the 1934 Act, 15 U.S.C. § 78bb. *See Iroquois Industries, Inc. v. Syracuse China Corp.*, 417 F.2d 963, 969 (C.A.2 1969), *cert. denied*, 399 U.S. 909, 90 S.Ct. 2199, 26 L.Ed.2d 561 (1970). Thus, for example, in *Birnbaum* itself, while the plaintiffs found themselves without federal remedies, the conduct alleged as the gravamen of the federal complaint later provided the basis for recovery in a cause of action based on state law. *See* 3 L. Loss, Securities Regulation 1469 (2d ed. 1961). And in the immediate case, respondent has filed a state-court class action held in abeyance pending the outcome of this suit. *Manor Drug Stores v. Blue Chip Stamps*, No. C-5652 (Superior Court, County of Los Angeles, Cal.).

Id. at 739 n.9.

In short, as this Court recognized in *Blue Chip Stamps*, while there may have been policy reasons for limiting federal claims to purchasers and sellers, it would be unjust to deprive wronged stockholders who are not sellers or buyers a remedy; and that injustice is only avoided if such stockholders can maintain a lawsuit or retain a remedy in state court.

B. Post *Blue Chip Stamps*

Subsequent to *Blue Chip Stamps* "holder" claims slid into what might be described as a dormant period due to reasons unrelated to any federal law concerns. The leading state Supreme Court issued a series of decisions that created ambiguity as to whether a "holder" claim could be brought as a "direct" claim or was, in fact, a "derivative"

claim. *Cf. Lipton v. News Intern., PLC*, 514 A. 2d 1075, 1078 (Del. 1986) (adopting "special injury" test), *with Kramer v. Western Pacific Industries, Inc.*, 546 A. 2d 348 (Del. 1988) (applying "nature of the wrong" test). For the most part, other state courts, following the Delaware Supreme Court's lead, incorporated this ambiguous line of cases into their corporate laws. *See, e.g., Loewen v. Galligan*, 130 Or. App. 222, 228-29, 882 P.2d 104, 111-12 (Or. App. 1994).[5]

This ambiguity, however, was resolved by the Delaware Supreme Court in a series of decisions starting with *Malone v. Brincat*, 722 A. 2d 5 (Del. 1998). In that case, a class action was brought on behalf of Mercury Finance shareholders seeking to recover damages arising out of a financial fraud that spanned more than three years. *Id.* at 7. The lower court had dismissed the action with prejudice as being derivative. The Delaware Supreme Court reversed and remanded, holding that a valid claim for damages arising out of fraudulent financial reporting could be brought by shareholders as a "direct" claim in their capacity as shareholders.[6] *Id.* at 14. Subsequently, in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A. 2d 1031, 1037 (Del. 2004) the Delaware Supreme Court rejected the "special injury" test and thus cleared the way for direct claims to be brought on behalf of shareholders for frauds whose disclosure thereafter caused a diminution in the value of their securities. In a similar fashion, the

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[5] The confusion arose from an initial formulation that held that any conduct that caused a diminution in value of the stock as to all shareholders as a whole was deemed to be a derivative claim. *Id.*

[6] *Malone* was a related case to the previously cited *Dloogatch v. Brincat* in which a class of holder claimants was certified.

Supreme Court of California also recognized that holder actions were valid and could be brought under California law. *See Small*, 39 Cal. 4th at 176, 132 Cal. Rptr. 2d at 496, 65 P.3d at 1260 (2003).

III. State Courts Should Be Allowed To Freely Develop The Law Regarding Holder Claims And Whether Such Claims Can Be Brought As Class Actions

Because the lower federal courts have declined to exercise subject matter jurisdiction over such "holder" claims since *Blue Chip Stamps*, resolving whether such "holder" claims are valid under the common law is, quite obviously, a question that has been and must be left to the respective state courts. In those states where "holder" claims have already been recognized, individual actions should be allowed to proceed and, by definition, cannot and will not be preempted by SLUSA. As a result, large individual investors who have substantial "holder" damages (and, thus, can economically afford to bear the substantial costs involved in pursuing such fraud claims) will have appropriate state court forums to vindicate their "holder" claims. Smaller investors who have been similarly harmed, however, will not be able to vindicate their claims unless they have the opportunity to pursue them as class actions.

Under their broad police powers and in the absence of a clear intention by Congress to preempt such claims, the states' legitimate interest in determining whether and how to protect both large individual "holder" claimants and smaller claimants who may need to join together in a class action should remain intact. Moreover, there is no reason why the individual states should be precluded from determining whether "holder" claims, under the appropriate

circumstances, should proceed as class actions. To allow SLUSA to preempt "holder" class actions, on the other hand, would produce a perverse result. Large "holder" claimants would be allowed to pursue their claims in state court. Small "holder" claimants, to the extent that it would not be economical to bring their claims on an individual basis, would for all practical purposes be denied the opportunity for any relief whatsoever if such class actions were preempted under SLUSA.

Removal of state law based "holder" class actions would extinguish any right to pursue a class action for such claims because, under *Blue Chip Stamps*, holder claimants do not have standing under Section 10(b) of the 1934 Act. In contrast, small purchaser claimants whose state law claims can be brought as class actions under Section 10(b) do not have their right to pursue a class extinguished under SLUSA upon removal. They retain the right to pursue a class action under Section 10(b) if one has not already been brought. If a federal class action has already been brought, then at least their claims have the opportunity to be vindicated via a class action.

Thus, if SLUSA preempts their state law based class action, only small "holder" claimants are left with no opportunity to seek relief through the class action procedure. Yet, nothing in the language of SLUSA or in its legislative history indicates that Congress intended to completely extinguish the ability of any claimants to bring class actions, let alone "holder" claimants. Rather, Congress wanted to make sure that the practice of bringing state law based purchasers class actions to avoid the application of the PSLRA to claims that could have been brought under Section 10(b) would be governed by the PSLRA if the defendant chose to remove the action to

federal court. On this record, there is just no basis to justify the usurpation of what clearly is a state interest and state prerogative – the protection of smaller holder claimants who are defrauded and who, by definition, have no federal class action remedies.

Clearly, if such a result is to be achieved it can only be done pursuant to a clearly worded statute directed at this precise issue and not by an obtuse, convoluted misreading of the current statute as reflected in the Seventh Circuit's opinion in *Kircher*.

For this reason numerous courts have held that state law claims of misrepresentations or omissions that induce the plaintiff to retain stock can proceed in state court consistent with SLUSA. *See, e.g., Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 189 F. Supp. 2d 14, 18 (S.D.N.Y. 2001); *Dacey v. Morgan Stanley Dean Witter & Co.*, 263 F. Supp. 2d 706, 712 (S.D.N.Y. 2003); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 595 (W.D.Tex. 2001); *Lalondriz v. U.S.A. Networks Inc.*, 68 F. Supp. 2d 285, 286 (S.D.N.Y. 1999); *Gordon v. Buntrock*, 2000 WL 556763, *4 (N.D. Ill. April 28, 2000); *see also Hines v. ESC Strategic Funds, Inc.*, 1999 WL 1705503, *6 (M.D.Tenn. Sept. 17, 1999) ("Because Plaintiff has alleged that the defendants' breach of their fiduciary duties resulted from their actions after she purchased her shares, Plaintiff's post-sale allegations are sufficient to withstand a motion to dismiss" based on SLUSA). As set forth below, there is good reason for this consensus.

IV. SLUSA Does Not Preempt State "Holder" Claims

It is through the prism of both the long history of judicial decisions interpreting the phrase "in connection with the purchase or sale of any security" as part of Rule 10b-5 jurisprudence and the purpose of SLUSA by which the phrase "in connection with the purchase or sale of a covered security" in SLUSA should be viewed. Although the starting point of statutory construction is the language of the statute itself, *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring), the phrase in question was not written on a blank slate, but after decades of use and interpretation by this Court and lower federal courts. "[W]here Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d at 1342 (11th Cir. 2002).

A. Purpose of PSLRA and SLUSA

In 1995, in response to perceived abuses of the federal securities laws through the filing of class actions of dubious or no merit, Congress passed the PSLRA. *See* Private Securities Litigation Reform Act of 1995, H.R. Conf. Rep. No. 104-369, *32 (Nov. 28, 1995), reprinted in 1995 U.S. Code Cong. Admin. News 730 ("the abuse of the discovery process [] impose[s] costs so burdensome that it is often economical for the victimized party to settle"). *See also Greebel v. FTP Software, Inc.*, 194 F.3d 185, 191 (1st Cir. 1999) (PSLRA passed to curb abuse in private securities lawsuits). In addition to enacting certain procedural

requirements concerning publication of the filing of an action and appointment of lead plaintiff, the PSLRA codified "loss causation" requirements, established a safe harbor for forward-looking statements, and raised the pleading requirement for the required state of mind. *See* 15 U.S.C. § 78u-4(b)(4) (codifying loss causation); 15 U.S.C. § 78u-5 (codifying safe harbor); 15 U.S.C. § 78u-4(b)(2) (codifying scienter requirements). The response of some defrauded investors was to file their purchaser cases in state court, thereby avoiding some of the PSLRA's more onerous requirements. In 1998 Congress enacted SLUSA in response to this perceived end run around the PSLRA. "Driving enactment of SLUSA was Congress' finding that litigants eluded PSLRA's reach with relative ease. Confronted with more onerous procedural requirements and dimmed prospects of success under the PSLRA, litigants simply abandoned use of federal courts and filed suit in state court under state securities laws." *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 123 (2d Cir. 2003). Thus SLUSA's intended purpose was to ensure that actions which were actionable under federal securities laws would be brought in federal court and subject to the PSLRA's strict requirements.

B. Scope of Private Remedies Under Federal Securities Laws

A private cause of action under Section 10(b) of the 1934 Act, prior to the PSLRA, was an implied cause of action because private actions under Section 10(b) were not specifically authorized in the 1934 Act. *See Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). As explained *supra*, this

changed in 1995 when the PSLRA codified certain elements of a cause of action under Section 10(b), including loss causation and scienter.

Since the contours of a private action under Section 10(b) were shaped by judicial opinions without the benefit of statutory guidance, the federal courts were left to decide issues such as standing on their own. In the decades that followed the 1930s and 1940s, the prevailing view on standing under Section 10(b) became the Second Circuit's opinion in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952). *Birnbaum* held that a plaintiff had to actually purchase or sell a security in order to satisfy the "in connection with" requirement of SEC Rule 10b-5. *Id.* at 463-64. In *Blue Chip Stamps*, this Court adopted the *Birnbaum* rule, holding that the "in connection with" requirement for a private action under Rule 10b-5 could only be met by a plaintiff who had actually purchased or sold the securities in question. *Blue Chip Stamps*, 421 U.S. at 754-55.

Blue Chip Stamps was premised on a balancing of the advantages and disadvantages of including non-purchasers and non-sellers within the ambit of protection under the implied cause of action under Section 10(b) of the 1934 Act.[7] The advantages of the restrictive *Birnbaum* rule were that it would eliminate what the Court perceived as speculative claims flooding the federal courts[8] –

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[7] In *Blue Chip Stamps* this Court found this balancing proper since private actions were a "judicial oak which ha[ve] grown from little more than a legislative acorn," and neither the 1934 Congress nor the SEC in 1942 anticipated the state of Rule 10b-5 in 1975. *Id.* at 737.

[8] This was particularly true for "[d]isappointed" purchaser claims where the gravamen of the claim would be that the frauds discouraged

(Continued on following page)

claims which would be harder to dispose of via pre-trial procedures because the claim might ultimately hinge on oral testimony concerning whether the plaintiff would have bought the stock. *Id.* at 742. By adopting the *Birnbaum* rule, this Court found that there would at least have to be some objective evidence regarding the fact that a purchase or sale took place. *Id.* at 747.[9] The disadvantage of the *Birnbaum* rule were that potential meritorious shareholder claims would be barred from the federal courts. *Id.* at 738-39.

C. The Second Circuit's Decision Is Correct

1. The Court Properly Considered Long-standing Interpretations Of "In Connection With"

It was proper and correct for the court below to consider the established meaning of "in connection with" when construing the parameters of SLUSA.

> In enacting SLUSA . . . Congress was not writing on a blank slate; instead it was legislating in an

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investors from purchasing a particular stock. This sort of claim could be manufactured based upon oral testimony any time a stock precipitously increased in value and would, quite obviously, present problems. In contrast, a "holder" claim is subject to objective evidence – a holder claimant actually owns the stock in question. The only issue that might be subject to oral testimony is whether the investor relied on the frauds. In cases not involving fraud on the market, investors must establish their reliance and this normally is accomplished through oral testimony.

[9] The same objective evidence exists for "holder" claimants – they own the stock and whether they owned it during the fraud period can also be objectively established.

> area that had engendered tremendous amounts of litigation and received substantial judicial attention . . . [Congress] was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits.

Riley, 292 F.3d at 1342-43. It is valid to assume that Congress, when it used the phrase "in connection with" in SLUSA, was using its accepted meaning in the federal securities laws. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 36 (2d Cir. 2005); *Riley*, 292 F.3d at 1343. The circuit courts that have adopted this approach simply followed this Court's established precedent. "When . . . judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also Lorillard v. Pons*, 434 U.S. 575, 581 (1978) (Congress can be presumed to have knowledge of interpretations of law incorporated into a new statute).

2. The Standing Rule of *Blue Chip Stamps* Is Properly Applied to SLUSA's "In Connection With" Language

In this case, the Second Circuit aptly stated:

> If the "in connection with" phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the

> heightened requirements of the PSLRA. If it were otherwise, actions might be preempted for meeting all of SLUSA's requirements, including the "in connection with" term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.

Dabit, 395 F.3d at 36. The *Dabit* court was absolutely correct in finding SLUSA was merely meant to preempt federal actions masquerading as state actions, and not meant to preempt state actions which never could be brought as federal actions.

The *Dabit* court correctly applied the *Blue Chip Stamps* standing rule. The Second Circuit reviewed the claims of two distinct class action plaintiffs, Shadi Dabit, a former Merrill Lynch broker; and IJG Investments Limited Partnership and Irlys Guy (collectively, "IJG"). *Id.* at 28-29. In the cases of both Dabit and IJG, the Second Circuit carefully examined each of the plaintiffs' claims for any allegation that was "in connection with" or "coincided with" a security transaction, and where it found that the allegation included a transaction that fell within the *Blue Chip Stamps* rule, that claim was dismissed as preempted under SLUSA.

3. SLUSA Does Not Completely Preempt All State Class Actions Which Might Involve Publicly Traded Securities

This Court has held that "in deciding if federal law preempts state law . . . we start with the assumption that the historic police powers of the States were not to be

superseded by the Federal Act unless that was the clear and manifest purpose of Congress." *City of Milwaukee v. States of Illinois and Michigan*, 451 U.S. 304, 316 (1981). The express language of SLUSA does not provide that all state actions involving publicly traded securities are preempted. In fact, it states just the opposite namely, that it is intended to "prevent *certain* State private securities class action lawsuits alleging fraud from being used to frustrate the objectives" of the PSLRA, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (emphasis added). Because the objectives of the PSLRA concerned only federal securities lawsuits permitted under the *Blue Chip Stamps* rule, other state private actions which historically were excluded from the ambit of Section 10(b) could not possibly have been the target. Further, there is nothing in the legislative history of SLUSA to indicate that was Congress' intent.

The conference report states the purpose of SLUSA is "to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court." Securities Litigation Uniform Standards Act of 1998, H.R. Conf. Rep. No. 105-803, at 13, 1998 WL 703964 (Oct. 9, 1998). The protection federal law provided against supposedly abusive litigation were the procedural and pleading requirements imposed by the PSLRA, which only applied to lawsuits which could be filed in federal court in the first instance. Thus there is no support either in the text of the statute or the legislative history of SLUSA for a finding that it preempts every possible state class action involving publicly traded securities, including those which could never have been filed in a federal court.

V. The Seventh Circuit's Decision In *Kircher* Is Premised On Faulty Assumptions

In *Kircher*, the Seventh Circuit misinterpreted *Blue Chip Stamps* and SLUSA and it therefore reached the incorrect decision when it held that "holders" claims satisfied the "in connection with" requirement of SLUSA and were preempted. *Kircher* contained a lengthy discussion of *Blue Chip Stamps* and how the decision reflected a policy decision to limit private causes of action to actual purchasers or sellers. 405 F.3d at 482-83. However, *Kircher* went awry when it stated:

> It would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all.

Id. at 484. This holding reflects a misunderstanding of both SLUSA and *Blue Chip Stamps*. As explained *supra*, SLUSA was passed to ensure that actions which are subject to the federal securities laws are filed in federal court, subject to the rigors of the PSLRA, and not under parallel state provisions. It was not meant to ensure that, as *Kircher* stated "securities class actions must proceed under federal securities laws or not at all." Moreover, while the *Blue Chip Stamps* court did block private litigation by non-traders, it did so only in federal court under the federal securities laws, and only because, *inter alia*, those non-traders could pursue remedies under state law. *Blue Chip Stamps*, 421 U.S. at 739 n.9. It would be "more

than a little strange" *not* to allow these purely state cases to be pursued in state court, especially when it was the judgment of Congress simply not to allow federal cases to be filed in state court. There is no evidence Congress meant to preempt claims which never could have been filed in federal court in the first place.

CONCLUSION

Accordingly, NASCAT and AARP respectfully request this Court affirm the decision of the Second Circuit in this matter.

Respectfully submitted,

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December 16, 2005

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS COUNTY DEPARTMENT - CHANCERY DIVISION

MICHAEL DLOOGATCH, on behalf of himself and all others similarly situated, Plaintiff, v. JOHN N. BRINCAT, JOHN N. BRINCAT, JR., WILLIAM C. CROFT, MERCURY FINANCE COMPANY, and KPMG PEAT MARWICK, Defendants.	No. 97 CH 8790 Judge Patrick E. McGann Cal. 6

MEMORANDUM OPINION AND ORDER

Plaintiff Michael Dloogatch, on behalf of himself and all others similarly situated, moves, pursuant to Section 2-801 of the Illinois Code of Civil Procedure, 735 ILLS 5/2-801, to certify a class of "people who owned the common stock of Mercury Finance Company on or before February 23, 1994 and held their stock through and including January 29, 1997." Defendant KPMG Peat Marwick ("KPMG") objects to class certification with respect to each of Section 2-801's requirements.

I. FACTS

Plaintiff Michael Dloogatch ("Plaintiff" or "Dloogatch") has entered into a class-wide settlement agreement with Mercury Finance Company ("Mercury") and the individual defendants. KPMG, who acted as Mercury's accounting

firm and independent auditor of its financial statements, is the only remaining defendant in this cause. In the complaint, plaintiff seeks recovery against KPMG for negligence, negligent misrepresentation and common law fraud, claiming that during the period from February 23, 1994 through January 29, 1997, KPMG issued to the class members, all of whom were shareholders in Mercury, false and misleading auditor's letters certifying the accuracy of Mercury's financial statements that falsely portrayed Mercury's revenues, earnings and financial condition.

Plaintiff seeks to certify a class of holders of Mercury stock that owned Mercury stock on the last day before the fraud began, February 23, 1994, and who held their stock during the three-year period when the fraud was revealed on January 29, 1997. On January 29, 1997, Mercury announced that previously reported net income for the fiscal years 1993 through 1996 would be restated due to the discovery of accounting irregularities. According to the plaintiff, those false and misleading financial statements and auditor's letters misled the holders into believing that Mercury was a going concern with a bright future, only to experience substantial losses when the truth about Mercury's poor financial condition was disclosed on January 29, 1997. The plaintiff claims that he and the remaining members of the proposed class would not have held onto the stock, if not for the false reported earnings and auditor's letters.

Plaintiff has defined the class as:

> All persons who purchased common stock of Mercury Finance Company prior to February 23, 1994 and held such stock through and including January 29, 1997. Excluded are KPMG and any entity which KPMG has a controlling interest or

which is a parent or subsidiary of or is controlled by KPMG, and the officers, directors, employees, affiliates, legal representatives, heirs, successors and assigns of KPMG.

II. DISCUSSION

Section 2-801 of the Illinois Code of Civil Procedure, 735 ILCS 5/2-801, provides for the maintenance of a class action in Illinois. Under this section, the court must find that: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of fact or law common to the class, which common questions predominate over any questions affecting only individual members; (3) the representative parties will fairly and adequately protect the interest of the class; and (4) the class action is an appropriate method for the fair and efficient adjudication of the controversy.

In deciding whether to certify a class, a court may consider "any matters of fact or law properly presented by the record, including the pleadings, depositions, affidavits, answers to interrogatories and any evidence that may have been adduced at the hearings." *Charles Hester Enterprises, Inc. v. Illinois Founders Insurance Co.*, 137 Ill. App. 3d 84, 100 (5th Dist. 1985). This decision is left to the sound discretion of the trial judge and will be disturbed only upon a finding of a clear abuse of discretion or the application of impermissible legal criteria. *Slimack v. County Life Insurance Co.*, 227 Ill. App 3d 287, 292. (5th Dist. 1992).

1. Numerosity

The numerosity portion of the Illinois statute is identical to the language found in Rule 23 of the Federal Rule of Civil Procedure. Thus, decisions of the federal courts on this issue are instructive. *Wood River Area Development Corp. v. Germania Federal Savings and Loan,* 198 Ill. App. 3d 445, 450 (5th Dist. 1990).

Although the easiest factor to find, the issue as to whether the proposed class is large enough to make joinder of all members impracticable is not subject to arithmetic certainty and depends on the facts and circumstances of each case. In *Wood River,* the Appellate Court noted that courts, either federal or state, have not established a "magic number" which guarantees certification. The court did, however, point with authority to a quote from Miller, *An Overview of Federal Class Actions: Past, Present and Future*, Federal Judicial Center, at 22 (1977), which stated:

> If the class has more than forty people in it, numerosity is satisfied; if the class has less than twenty-five people in it, numerosity is probably lacking; if the class has between twenty-five and forty, there is no automatic rule and other factors . . . become relevant,

In *Wood River*, where there was twenty-one potential class members, reduced to eighteen after three opted out, the Court held that because the size was relatively small, additional reasons for the use of the class action procedural device was appropriate. These additional factors are: (1) the class members geographical distribution; (2) the ability to identify and locate the class members; (3) the degree of knowledge and sophistication of the class members and

their need for protection; (4) the amount of claims of the individual class members; and (5) the nature of the cause of action. *Wood River*, 198 Ill. App. 3d at 451.

Dloogatch asserts that he has met this numerosity requirement, using as an example that over 1000 class members have filed valid claims for their share of the settlement of claims against the other defendants in this matter. KPMG claims that Dloogatch cannot meet the numerosity requirement because there is a strong reason to believe that many of the class members who sought compensation against other defendants have since released any claims they had against KPMG. Specifically, KPMG argues that since two classes of purchasers of Mercury securities have released their claims against KPMG in a federal case, all putative members of the holder class who also purchased Mercury securities during the class period and have not opted out of the purchaser class, have released their claims and cannot be members of the holder class. KPMG points out that 53 of 61 institutional investors had purchased stock during the class period, and have thus, released their claims against KPMG. KPMG also argues that at least 14 individual plaintiffs have asserted individual claims against KPMG and are in a position to assert their rights without relying on the class action device. The Plaintiff denies the effect of the releases.

Here, KPMG is correct that certain potential class members may have released their claims against certain holders but its argument ignores the fact that at least some holders were not also purchasers during the class period. The releases executed as part of the previous settlement, Exhibit 5 to Defendant's Memorandum, appear to affect only those persons who purchased Mercury stock

on and after April 10, 1995 and up to and including January 29, 1997. The document also absolves KPMG of liability for any and all services they performed for Mercury during that time period. On its face, the settlement agreement appears to exclude any putative member of the "holder class" who purchased additional shares of Mercury stock during the applicable period. It does not impact on those investors, who purchased the stock prior to February 1994 and held the stock until January, 1996. The exact number of individuals in either category is not left to speculation. Mercury was an actively traded security. More than thirty thousand notices were mailed in connection with a previous settlement. A number of institutional investors did not settle their claims. In addition, the defendant's expert, Mr. Cox' statistics suggest a significant amount of ownership retention in his analysis of Mercury's trading volume at the time of the financial reports.

In addition, the Plaintiff's suggestion that there are at least one hundred thirty members of the proposed class is persuasive. The defendant's arguments and illustrations are not sufficient to defeat the plaintiff's assertion that those holders meet the numerosity requirement, because the numerosity requirement generally requires only about forty class members. If the Plaintiff's class is as small as the defendant suggests, the issues relating to the predominance of common questions of reliance may not be as cumbersome as suggested. Therefore, the plaintiff has met the numerosity requirement.

2. Common Questions of Law or Fact.

Prior to the enactment of Illinois' class action statute, common law required that a party seeking to be a representative in a class suit have a community of interest in the subject matter and the remedy. *Harrison Sheet Steel Co. v. Lyons*, 15 Ill. 2d 532, 537 (1959). This standard precluded a party opposed to the class from interposing an objection by asserting hypothetical versions of a minor character to prevent use of the class suit procedure. *Lyons*, 15 Ill. 2d at 538.

Shortly after Section 2-801 was enacted, then codified as SHA Ch. 110 § 57.2, the Supreme Court issued its decision in *Steinberg v. Chicago Medical School*, 69 Ill. 2d 320 (1977). The plaintiff, Robert Steinberg, had applied for admission and paid the required fee to the defendant medical school based upon its promise to make acceptance decisions upon the criteria stated in its catalog. This booklet emphasized academic achievement and potential as the primary factors considered for admission. He alleged that unbeknownst to him and others similarly situated a candidate's chance of acceptance increased in direct proportion to the contribution or pledge of contribution to the school's endowment fund. After finding the former "community of interest" standard lacked structure, the Court set forth the simple test of finding common questions of law or fact. It also recognized that slight deviations of claims by some portion of the class will not in and of itself serve to defeat certification. *Steinberg*, 69 Ill. 2d at 338.

As recognized by *Steinberg*, the standard now set out by the legislature requires the court to perform a two-step analysis. First, the court must ask whether there are

common questions of law or fact. The language is in the disjunctive; therefore, the commonality can be in fact or law. If there are common questions of law or fact, the trial court must determine whether the common questions predominate over questions involving individual members.

In this case, Dloogatch asserts that the common question of law or fact is whether KPMG is liable for its conduct in auditing Mercury and disseminating the audit opinion letters, and also claims that it is appropriate to prove the class' actual reliance through circumstantial evidence sufficient to create an inference of reliance. This is a reasonable position as corporate financial statements are distributed to shareholders with an invitation they be read and relied upon.

The Supreme Court of California has recently noted the importance of the need for integrity in our financial markets. The financial hardships reported in our daily papers caused by shoddy or unethical business practices shielded by inadequate or corrupt oversight by outside auditors affect every resident of this country either directly by a loss of wealth or indirectly by increased costs imposed because risk cannot be accurately gauged. see *Small v. Fritz Companies*, 30 Cal. 4th 167 (2003). Thus, the role of KPMG in preparing the audit letters and other financial reports which the Plaintiff alleges caused his loss is a critical issue in this litigation.

KPMG argues that the highly individualized question of reliance is the predominant issue in this case. KPMG additionally objects that plaintiff's class-wide theory of damages do not present predominant common issues because case law rejects plaintiff's benefit of the bargain

theory of damages because holders cannot claim the benefit of any bargain.

The Court accepts for the purpose of this motion that the audit and financial reports prepared by KPMG and distributed to shareholders by Mercury, served to a very great extent, to set the market price of the stock. It also must be assumed that the stock price was artificially inflated by the fraudulent financial statements. The Court acknowledges KPMG's strong denial of any wrongdoing. As noted, the statements were distributed to furnish information to the shareholders and others either making or advising on investment decisions. The gravamen of fraud and negligent misrepresentation is reliance on the falsehood. That means the injured party must do something as a result. That can be either action or, as alleged in this case, inaction. *Wright v. Chicago Title Insurance Co.*, 196 Ill. App. 3d 920, 926 (1990). KPMG posits that if the requirement of actual reliance were relaxed, individuals who never read the reports or relied solely on the market in making decisions to buy, sell or hold securities would have a claim. This would unjustifiably expose KPMG to potential liability for unsubstantiated claims and be inconsistent with the rule set down in *Oliveira v. Amoco Oil*, 201 Ill. 2d 134 (2002).

The danger of non-meritorious suits in securities cases has been recognized by the United States Congress with the enactment of the Private Litigation Securities Act of 1995 (109 Stat. 737). The United States Supreme Court also noted sensitivity to the issue of fraudulent claims in barring "Holders Actions" under federal securities laws *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739-740, 743-747 (1975). In a stated effort to reduce the potential of such suits, one state court now requires that a

Plaintiff making a state claim for fraud on a theory of "Holding" stock must allege with particularity "how, when, where to whom and by what means the representations were tendered as well as details concerning the abandoned decision to sell the security in question. *Small v. Fritz Companies, Inc.*, 30 Cal. 4th 167, 184 (2003). Claims for negligent misrepresentation must allege that if the true financial status were known, a sale would have occurred, how much stock would have been sold, and when the sale would have occurred. Id. The focus in each claim, the Court noted, was on the decision making process of the alleged injured party.

Plaintiff Dloogatch has asserted claims of common law fraud, negligence and negligent misrepresentation against KPMG. In order to state a claim for common law fraud or negligent misrepresentation, the plaintiff and all of the individual class members must prove justifiable reliance upon the truth of the misrepresentations. *Chicago v. Michigan Beach Housing Coop.*, 297 Ill. App. 3d 317, 323 (1st Dist. 1998); *Good v. Zenith Electronics Co.* 751 F. Supp. 1320, 1323 (N.D. 1990) (applying Illinois law); *In re First Merchants Acceptance Corporation Securities Litigation*, 1998 WL 781118 at 12 (N.D. Ill.) (applying Illinois law). Similar to *Fritz Companies*, the focus in these claims must be on the decision making process of the Plaintiffs.

Other courts considering such claims have rejected them as too speculative *Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011 (D. Conn. 1994) or required personal contact between the defendant and plaintiff as well as extrinsic proof. *Guthman v. Howard Savings Bank*, 748 F. Supp. 254 (D. N.J. 1990).

The plaintiff seeks to assert an inference of reliance, although he claims that he is not relying on the fraud on the market theory. The fraud on the market theory, used in securities fraud cases brought under Rule 10b-5 of the Securities Exchange Act of 1934, allows for a rebuttable presumption of reliance that a person purchasing stock relied on the integrity of the price as set by the market and that a misleading statement or omission by defendants resulted in a lower stock price. *Good*, 751 F. Supp. at 1323, citing *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). This presumption has been used to satisfy the plaintiff's requirement to plead and prove transaction causation. Plaintiffs most likely cannot rely on the fraud on the market theory because several courts have held that while the theory applies to securities fraud litigation, the theory does not apply to state common law actions for fraud and negligent misrepresentation. *Good*, 751 F. Supp. at 1323; *Katz v. Comdisco*, 117 F.R.D. 403, 412 (ND. Ill. 1987). Moreover, the Illinois Supreme Court has recently rejected the theory's application to a claim under the Illinois Consumer Fraud Act. *Oliveira v. Amoco Oil Co.*, 201 Ill. 2d 134 (2002). The Court required such plaintiffs to show the injury was proximately caused by the acts of consumer fraud. It is important to note that the Supreme Court's decision expressed a concern that the use of the fraud on the market theory would allow individuals who did not hear or believe the admittedly false advertising to recover unjustly.

Dloogatch's position is a variation of a theory found in the earlier cases authorizing a "holder's claim" in securities litigation. In *Continental Insurance Company v. Mercandante*, 225 N.Y.S. 488 (S. Ct. App. Div. 1927), the court was called upon to determine if a claim for fraud

could be stated where the plaintiff insurance companies did not allege that the defendant's fraud did not cause the plaintiffs to change their decision to sell the securities. Rather, the wrong occurred when the misrepresentation "transmuted their indecision whether to sell or keep into a damaging decision to retain." The court noted that the plaintiffs had acted in a manner suggested by the misstatements, retain the security as a valuable investment. This the court held showed, at the pleading stage, *prima facie* legal causation. The court reasoned the question was not whether the deceived party would have lost had the fraud not been practiced, but whether there was a reasonable probability that the fraud actually accomplished the result it was intended to bring about. Here, the allegations in the complaint set forth a series of deliberate acts done by KPMG which were intended to influence investor decisions related to purchase, sale, or retention of stock in Mercury Finance Company.

Subsequent to the *Mercandante* decision, the Congress enacted the depression era securities laws. The rights of investors under these statutes were the focus of fraud litigation over the ensuing four decades. While state fraud claims were prosecuted, they were usually pendant to the predominant action under section 10b of the Securities Exchange Act of 1934. The law that developed under that scheme required a plaintiff to establish loss causation as well as transaction causation in order to successfully prosecute the action. *AUSA Life Insurance Company v. Ernst and Young*, 206 F3d. 202, 209 (2nd Cir. 2000). Loss causation is causation as defined in the traditional proximate cause sense. Id. Transaction causation on the other hand has been analogized to reliance because it means the violations in question caused the [injured party] to engage

in the transaction in question. Id. However, in a securities fraud case these two theories coalesce if the plaintiff can establish that the transaction would not have occurred but for the misrepresentation and that the misrepresentation created the disparity between the price and the "investment quality" of the security at the time of the transaction. *Castellano v. Young & Rubicam, Inc.*, 257 F.3d. 171, 187 (2nd Cir. 2001).

It necessarily follows, that if the *Mercantante* rule were accepted by this Court, a fact finder would be allowed to conclude that KPMG's alleged wrongdoing caused the market to react in reliance on their reports. Such a decision would run afoul of the Supreme Court's admonition against use of the market theory to establish causation.

As the plaintiff argues, it is true that the Illinois Supreme Court in *Steinberg* stated that having "one count based on fraud does not prohibit a class action." *Steinberg*, 69 Ill. 2d at 340. In understanding the import of that statement and the Court's reference to *Korn v. Franchard Corp.*, 456 F.2d 1206 (2nd Cir. 1972) (Claim for violation of securities law in sale of a limited partnership interest), the facts in Steinberg are instructive as is an analysis of Illinois law evolving after Korn.

In Steinberg, it was clear that the Court had found the defendant medical school had an equitable duty of disclosure to the applicants. The Court also noted the conflict in then existing Illinois case law as to this issue and finally suggested the trial court had certain options, such as subclasses or following the suggestions in *Korn*. It is also important to remember that in *Steinberg*, there were breach of contract and consumer fraud counts where reliance on the falsehood is not an element.

This Court accepts the principal that individual issues of reliance will not prevent certification. This is especially true where a common core of facts exist or other claims are joined and where reliance is neither presumed nor an element of the claim. See *Arenson v. Whitehall Convalescent and Nursing Home, Inc.*, (164 F.R.D. 659 ND Il. 1996) (overcharging patients for medication alleged to be fraud, consumer fraud, and RICO violation); *Eisenberg v. Gagnon*, 766 F. 2d 770 (3rd Cir. 1985) (common offering of sale of worthless tax shelters); *Green v. Wolf v. Wolf* Corporation, 406 F.2d 291 (2nd Cir. 1968) (sale of stock based on three prospectuses containing similar false representations); *In re Activision Securities Litigation*, 621 F. Supp. 415 (ND Cal. 1985) (sale of stock based on false prospectus, court allowed certification of state fraud claim joined with 10b-5 action certified without objection by defendant). The other cases cited by the Plaintiff also involve claims of fraud in the sale of securities or insurance based upon false sales material uniformly distributed.

The courts of Illinois have not adopted any of the suggestions found in *Korn*. The Plaintiff has not cited to one case where the traditional elements of a fraud claim has been relaxed by a court. Indeed, as noted, the Supreme Court recently reinforced the necessary requirement of pleading and proving proximate cause in these cases. See *Oliveira*, 201 Ill. 2d at 155.

Hence, this Court concludes there are significant individual questions related to the issue of reliance. This Court, however, must examine whether the individual questions of reliance in the instant case will predominate over the common questions of law or facts in the instant case. In undertaking this analysis, the Court is mindful of the important role the class action has played in protecting

individual investors from securities fraud. In order to make his claim, the Plaintiff must prove that KPMG knowingly made a false statement concerning the financial status of Mercury Financial. That the statement was made with the intent that investors rely upon it, that reliance occurred because the injured party had a right to rely on the falsehood. Finally, that damage was proximately caused by the reliance. *Siegel v Levy Organization Development Company, Inc.*, 153 Ill. 2d 534, 542-543 (1992). The determination of KPMG's role in auditing the financial records of Mercury will determine whether it knowingly made a false statement with the intent that investors rely on it. This would create a core set of facts upon which, if necessary, individual class members can present claims of reliance. The resolution of these issues, in this Court's judgment, predominates over all others. The determination of this core issue would relieve this Court and those small investors of the cost of multiple investigations and trials over that portion of the case. KPMG would avoid the multiple defense costs necessitated by multiple filings. Moreover, if the class is as small as suggested by KPMG, the later portion of the proceedings will be not burdensome at all. Common sets of interrogatories and other discovery tools can be devised. An administrative process designed to separate valid claims from those without merit can be employed. Thus necessitating trials in only the former cases.

This Court acknowledges that several federal and foreign state courts have denied class certification as to the state law claims on the basis that individual issues of reliance would predominate over any common question of fraud and negligent misrepresentation. *Katz*, 117 F.R.D. at 412; *Good*, 751 F.Supp. at 1323; *Gaffin v. Teledyne*, 611

A.2d 467, 474 (Del. 1992) (questions as to the element of justifiable reliance will inevitably predominate over common questions of law or fact). The notice provision of the Code of Civil Procedure (735 ILCS 5/ 2-803), unlike that of Rule 23 of the Federal Rules of Civil Procedure places no restriction on requiring certain information from putative class members to make a claim or become a member of the class. Information concerning decisions to hold the security and the basis of those decisions can be required and reviewed for sufficiency. If facially defective, they can be summarily rejected. If the proper claim is made, KPMG can pose the agreed upon interrogatories, engage in limited document production and depose the claimant, as well as, insist on an individual hearing to contest the claim. That trial however will be limited solely to the issues of reliance and damages. This procedure would not be unlike those employed in other mass tort cases. It is not unusual for courts to conduct a single trial in crash-related or toxic mass torts on limited issues. Once liability is established, individual trials are conducted on issues related to causation and damages. *Conte, Newberg, Newberg on Class Actions* Chapter 17 generally and Section 17.28 (4th Edition, Thomson/West 2002).

On the other hand if the responding class is too large, the court can decertify the class and allow the claimants to proceed individually with a binding finding of KPMG's wrongdoing as the benefit of class membership.

In addition, while Dloogatch's expert, Dr. Lewellen has asserted a benefit of the bargain calculation of damages, calculating the damages owed to all of the holders as the difference between the value of Mercury stock on the day before the fraud was revealed and the price after the fraud was revealed. KPMG argues that any theory of

damages which applies equally to all shareholders is a shareholder derivative claim, and must be pleaded as such. Moreover, KPMG asserts that this is not a benefit of the bargain case, because all class members purchased their Mercury stock before any fraud occurred and the need to subtract any gains from the alleged fraud presents a predominant individual issue that undermines any effort to calculate damages on a class-wide basis.

Plaintiff is correct that this Court need not determine the proper measure of damages at this instant, however, in Illinois the benefit of the bargain approach generally assesses the difference between the actual value of the property purchased and the value of the property had the representations been true. *Gerill Co. v. Jack L. Hargrove Builders*, 128 Ill. 2d 179, 196 (1989); *Giammanco v. Giammanco*, 253 Ill. App. 3d 750, 759 (2d Dist. 1993). In this case, it is unclear how the benefit of the bargain approach would be appropriate in determining the damages of individuals who purchased the stock before any fraud occurred and held this stock throughout the fraud. The price paid for the security was the value set by the market thus they received full value for their money. They held the stock for the entire period of the fraud and suffered damage once the truth was revealed. No claimant can receive any benefit from the inflated price as they would be profiting from a fraud. Thus it appears the benefit of the bargain approach would have no application. Moreover some class members may have sold the stock precipitously and received an artificially depressed price. The defendant's suggestion that any loss incurred must be offset by any gain received for stock sold during the fraud has significant equitable appeal. Finally, the Court in *Small v. Fritz Company*, supra. discussed many approaches to the

determination of damages which this Court finds of interest. Nevertheless, this Court need not determine the proper measure of damages, but notes benefit of the bargain damages appears to be an inappropriate measure.

The final point on this issue is whether the claims are personal or derivative. In order to make such a determination, the Court must determine the nature of the harm and the relief available upon success of the suit. In order to state a direct claim under Delaware law, the plaintiff must establish that the injury was one that is different than that suffered by the other shareholders or involves the contractual rights of the shareholder that are independent of the corporation's rights. *Kramer v. Western Pacific Industries. Inc.*, 546 A. 2d 348, 351 (Del. 1988). This determination is made from a review of the actual claims in the complaint, not its captions or stated intentions. Id. P. 352. Here, the Plaintiff's [sic] allege an injury that is separate from any injury to the corporation. The injury is not related to corporate affairs or to their rights as shareholders. Their injury is personal to each of them. As the Defendant so eloquently argued each shareholder's loss or damage is unique to him or her. There is no commonality. Their rights do not derive from those of the corporation. Their injury, if any, derives from their right to purchase securities in a free, open and honest market. This right was violated, they allege, by the intentional acts of KPMG. The Defendant vigorously denies the allegations and so the issue is joined.

3. Adequate Representation

This requirement has due process implications. In order to determine adequacy of representation, the trial

judge must examine two issues: (1) will representation by the proposed class representative protect the members of the class who must be afforded due process; and (2) does the attorney have the skill, qualifications and experience to conduct the proposed litigation? *Steinberg*, 69 Ill. 2d at 339.

A. Adequate Representation by Proposed Representative

Unlike the requirement in Rule 23 of the Federal Rules of Civil Procedure that the claim of the proposed class representative be typical of those of the class, Illinois has adopted a more liberal approach. *Carrao v. Health Care Service Corp.*, 118 Ill. App. 3d 417 (1st Dist. 1983). In Illinois, the class representative must fairly, adequately and efficiently represent absent class members. *Gordon v. Boden*, 224 Ill. App. 3d 195, 203 (1st Dist. 1991).

This has been defined as showing the interest of the proposed class representatives are not antagonistic to those of the absent class members. Thus, issues such as slight variations in the claim, *Purcell Wardrope Chtd. v. Hertz Corp.*, 175 Ill. App. 3d 1069, 1078 (1st Dist. 1975), or individualized affirmative defenses, *Wenhold v. AT & T*, 142 Ill. App. 3d 612, 619 (1st Dist. 1986) will not defeat certification. However, in cases where there is evidence of antagonism or collusion, *Hansberg v. Lee*, 311 U.S. 32 (1940), between the proposed representative and absent class members or a close connection with the lawyer representing the proposed class, *Barliant v. Follett Corporation*, 74 Ill. 2d 266 (1978), class certification should be scrutinized.

In this case, KPMG argues that Dloogatch will not adequately represent the interests of the class because he is subject to a defense that he cannot prove that he relied on any fraudulent statement because he did not sell the stock even after the alleged fraud was revealed in January 1997 and if Dloogatch intends to rely on its alternative theory of damages, opportunity cost, he is a poor representative. These individualized affirmative defenses, which can be explained by deposition testimony, are not sufficient to undermine Mr. Dloogatch's ability to adequately represent the class.

B. Adequacy of Representation by Counsel

KPMG does not assert that counsel will not adequately represent the potential class. Moreover, this Court has read pleadings submitted by counsel and has determined that counsel will adequately represent the class.

For these reasons, the adequate representation prong is met.

3. Appropriate Method for Fair and Efficient Adjudication

In its earliest explanation of this prong, the Supreme Court noted that once a determination was made that a question of law or fact common to the class predominates, the statute is satisfied. *Steinberg v. Chicago Medical School*, 69 Ill. 2d 320, 340-341 (1977). The court noted that once the dominant issue was resolved, the trial judge could employ various procedures to resolve issues that affect some, but not all of the class members. This could include breaking the class into identifiable subgroups or even ordering individual trials.

Later cases developed a two-pronged test to determine whether this requirement was met. Satisfaction of either test proves the statutory requirement. The test is whether: (1) the class action procedure can best secure the economics of time, effort and promote uniformity; or (2) accomplish the other ends of equity and justice that class actions seek to obtain. Furthermore, a controlling factor in many cases is that the class action is the only practical means for class members to receive redress, particularly where claims are small. *Gordon*, 224 Ill. App. 3d at 204-205.

This case is an appropriate method for the fair and efficient adjudication of the individual class issues. While the class action vehicle is not the only practical method for the class members to receive redress. As KPMG pointed out, numerous individual holder actions have been filed against it. There are, as noted, efficiencies to be gained from proceeding as a class action. The investigation into the relationship between KPMG and Mercury will be costly and time consuming. It will require extensive document production, multiple depositions and the use of expert witnesses. Individual investors probably do not have the ability or resources to undertake such a task. The class action vehicle was designed for this type of case.

Hence, the Court concludes the Plaintiff has established the requirements for Class Certification.

III. ORDER

A. This Court certifies as a class of Plaintiffs:

> All persons who purchased common stock of Mercury Finance Company prior to February 23, 1994 and held such stock through and including January 29, 1997. Excluded

are KPMG and any entity which KPMG has a controlling interest or which is a parent or subsidiary of or is controlled by KPMG, and the officers, directors, employees, affiliates, legal representatives, heirs, successors and assigns of KPMG.

B. The matter is set for case management conference to discuss, among other issues, the form and content of the notice to the certified class on 8/18, 2003, at 11:30 A.M.

JUDGE

DATED:_____ ENTERED: PATRICK McGANN – 1510
Judge 1510

No. 04-1371

FILED
DEC 19 2005
OFFICE OF THE CLERK
SUPREME COURT, U.S.

IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF NEW YORK, CALIFORNIA, CONNECTICUT, HAWAII, ILLINOIS, IOWA, MICHIGAN, MINNESOTA, MISSISSIPPI, MONTANA, NEW JERSEY, NEW MEXICO, OHIO, OKLAHOMA, OREGON, SOUTH CAROLINA, VERMONT, WASHINGTON, WISCONSIN AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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QUESTION PRESENTED

Whether SLUSA preempts state-law claims brought by holders of securities based upon misrepresentations, omissions, or manipulation.

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INTERESTS OF AMICI CURIAE

Amici States urge the Court to affirm the decision of the United States Court of Appeals for the Second Circuit in *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, holding that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227, does not preempt state-law class-action claims brought solely on behalf of persons who were fraudulently induced to hold or retain securities.

Amici States have a legitimate and compelling interest in preserving a business climate free from fraud and deceptive practices, and have used their police powers to achieve this goal for more than a century. In general, state-law private rights of action have been an important means of compensating victims of securities fraud and compelling compliance with securities laws. More specifically, state law has long provided remedies to investors fraudulently induced to hold or retain a security, *see, e.g., Duffy v. Smith*, 32 A. 371 (N.J. 1895), and, since 1975, state law has provided the *only* remedy for such investors, *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

SLUSA displaces this historic exercise of the States' police power, thereby disrupting the balance of state and federal power that has long operated in the securities arena. For this reason, this Court's precedent dictates, and Amici States strongly agree, that the scope of SLUSA's preemption must be strictly limited to those causes of action that Congress explicitly intended to preempt: actions "in connection with the purchase or sale of a . . . security," a phrase which has previously been defined by this Court in *Blue Chip Stamps* to exclude private actions brought by nonpurchasers or nonsellers. Thus, SLUSA cannot be construed as displacing state-law causes of action for holder claims. To hold otherwise would eliminate remedies long available to injured investors, and strip States of essential authority to protect their citizens from fraud in securities transactions.

SUMMARY OF ARGUMENT

SLUSA does not preempt claims brought solely on behalf of plaintiffs who were fraudulently induced to hold or retain a security. Because States have traditionally policed securities fraud, a presumption against preemption applies here, and Petitioner has offered nothing sufficient to overcome it. The text of SLUSA limits its preemptive effect to state class actions alleging fraud "in connection with the purchase or sale of a . . . security." More than twenty years before SLUSA was enacted, this Court interpreted the exact same phrase to limit the scope of an implied private right of action for securities fraud, holding that plaintiffs who did not themselves purchase or sell a security do not have standing to bring a federal securities fraud action. *Blue Chip Stamps*, 421 U.S. at 725-49. Because Congress borrowed language with a settled and widely acknowledged meaning in enacting SLUSA, this Court, as it has done in the past, should presume that Congress was aware of this interpretation and intended to incorporate it as well.

Moreover, allowing States to continue to provide remedies for holder claims strikes an appropriate balance between protecting investors from fraud, while furthering Congress's purpose of discouraging vexatious securities litigation. Investors who hold securities in reliance on a corporation's material representations are surely vulnerable to fraud. Construing SLUSA to preempt such claims would leave these investors with extremely limited recourse. Absent any indication that Congress intended to take away longstanding state-law remedies, their elimination would be wholly unwarranted here.

ARGUMENT

I. SLUSA incorporates the well-settled purchaser/seller limitation on private actions for securities fraud and therefore does not preempt state-law holder claims.

A. Because States have had a longstanding role in protecting against securities fraud, there is a presumption against finding that SLUSA preempts holder claims.

Where a federal statute contains an express preemption provision, as SLUSA does, the task of a reviewing court is to "identify the domain expressly pre-empted by that language." *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 484 (1996) (internal quotation marks and citation omitted). This Court has "never assumed lightly that Congress has derogated state regulation, but instead [has] addressed claims of pre-emption with the starting presumption that Congress does not intend to supplant state law." *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 654 (1995). The Court "must fairly but — in light of the strong presumption against pre-emption — narrowly construe the precise language" of a federal provision alleged to preempt a state-law cause of action. *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 523 (1992). Thus, the Court "'start[s] with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.'" *Medtronic*, 518 U.S. at 485 (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).

The field of securities regulation is one in which States have long exercised their police powers to protect citizen investors, and thus state law should not be deemed preempted without explicit direction from Congress. State common law has long provided remedies for persons injured in securities transactions. Richard W. Painter, *Responding to a False Alarm:*

Federal Preemption of State Securities Fraud Causes of Action, 84 Cornell L. Rev. 1, 20 (1998) (contract remedies for injuries arising out of securities transactions include breach of warranty and rescission and tort remedies include fraud, deceit, and negligent misrepresentation). For more than a century, States have allowed recourse for precisely the type of claim at issue here: fraudulent inducement to hold a security. *See, e.g.*, *Small v. Fritz Cos.*, 30 Cal. 4th 167, 173-83, 65 P.3d 1255, 1258-65 (2003) (cause of action for stockholders induced by fraud or negligent representation to refrain from selling stock); *David v. Belmont*, 291 Mass. 450, 450-54, 197 N.E. 83, 83-85 (1935) (cause of action for fraud where plaintiff alleged defendants fraudulently induced him to hold stock); *Seideman v. Sheboygan Loan & Trust Co.*, 198 Wis. 97, 102-03, 223 N.W. 430, 433 (1929) (cause of action for fraud where bondholder was induced into holding bonds); *Fottler v. Moseley*, 179 Mass. 295, 296-99, 60 N.E. 788, 788-89 (1901) (cause of action for fraud where stockholder was induced to refrain from selling his stock); *Duffy*, 32 A. at 372 (cause of action for fraud where plaintiff retained stock in reliance on defendant's misrepresentations); *Ward v. Atlantic Sec. Bank*, 777 So. 2d 1144, 1146 (Fla. Dist. Ct. App. 2001) (cause of action for fraud where investor alleged defendant fraudulently induced him to hold his shares in a fund); *Continental Ins. Co. v. Mercadante*, 222 A.D. 181, 183-84, 225 N.Y.S. 488, 490-91 (1927) (cause of action for fraud and deceit where plaintiff alleged he was induced to retain securities).

State regulation of securities transactions has an equally long lineage. States began regulating securities in the nineteenth century by imposing registration requirements on certain types of securities offerings, and, in 1911, Kansas enacted the first "Blue Sky Law," which set forth a comprehensive system of registering securities brokers and offerings of securities of all types of enterprises. James D. Cox, et al., *Securities Regulation* 16 (1997). By 1933, nearly every State had enacted such a statute, and today all fifty States and the District of Columbia have Blue

Sky Laws. *Id.* at 16-17; *see also* 1 Louis Loss & Joel Seligman, *Securities Regulation* 41 (3d ed. 1998). Most of these statutes preserve common law remedies and include civil liability provisions that are in addition to and distinct from common law liability. 9 Loss & Seligman, *supra*, at 4114-66.

The crash of the stock market in 1929 led to federal regulation of the securities markets. *See, e.g.*, Cox, *supra*, at 3-16. The purpose of the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 ("1933 Act"), was to provide investors with full and fair disclosure by regulating disclosures in stock registration statements and prospectuses, and the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 ("1934 Act"), provided for the regulation of national securities exchanges to prevent inequitable and unfair practices in the buying and selling of securities. Significantly, while Congress sought to use federal regulation to correct certain inconsistencies in state blue sky laws, it did not preempt state law. Instead, the 1933 and 1934 Acts explicitly preserved state authority and thus established a dual system of securities regulation. *See* 1933 Act, ch. 38, § 16, 48 Stat. at 84 (codified as amended at 15 U.S.C. § 77p) (the rights and remedies prescribed by the 1933 Act are "in addition to any and all other rights and remedies that may exist at law or in equity"); 1934 Act, ch. 404, § 28(a), 48 Stat. at 903 (codified as amended at 15 U.S.C. § 78bb(a)) (expressly preserving state-law remedies).

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (the "Reform Act"), in an effort to curb federal "strike suits" — meritless securities class actions brought to force defendants into large settlements. The Reform Act set forth various procedural requirements for federal securities class actions, making it more difficult for plaintiffs' lawyers to file frivolous class actions. *See* 15 U.S.C. §§ 77z-1(b), 78u-4(b). Even as it reformed federal securities litigation, however, Congress continued to preserve state-law remedies and maintain a balance

between federal and state power in this area. *See Securities Litigation Uniform Standards Act of 1997 – S. 1260: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 34 & n.33 (1998) (hereinafter "*1998 Hearing on S. 1260*") (prepared statement of Richard W. Painter, Professor, Cornell Law School) (citing *Hearings Concerning Common Sense Legal Reform Act Before the Subcomm. on Telecomm. and Finance of the H. Comm. on Commerce*, 104th Cong. 110 (1995)).

In 1998, Congress concluded that some plaintiffs' lawyers were circumventing Reform Act requirements by filing securities class actions in state court instead of federal court. SLUSA was enacted to close this perceived loophole. The statute amended the 1933 and 1934 Acts to expressly preempt certain state-law class actions. *See* H.R. Conf. Rep. No. 105-803, at 13 (1998). In doing so, SLUSA became the first federal legislation to displace state-law private causes of action as a remedy for securities fraud.

In addition to displacing longstanding state authority, SLUSA's preemption dramatically limits the recourse available to injured and deserving plaintiffs. If the statute is construed to preempt state-law holder class actions, then persons fraudulently induced to hold a security will be left without a class-action remedy. *See infra* at 16. The Court should be particularly reluctant to expand the scope of a statute's preemption beyond Congress's express intent where, as here, doing so would wholly deprive deserving litigants of a cause of action. *See, e.g.*, *Medtronic*, 518 U.S. at 487 (plurality opinion) (because there is no federal private cause of action against manufacturers, preemption of state-law negligence claims would "have the perverse effect of granting complete immunity from design defect liability"); *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251 (1984) (finding it "difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct"); *Franchise Tax Bd. v. Construction Laborers Vacation Trust*, 463 U.S. 1, 26 (1983)

(Congress's failure to provide a federal right of action to vindicate a preempted claim provided further evidence that Congress did not mean for ERISA to preempt claims that were not explicitly identified in the statute).

Because SLUSA alters the longstanding shared authority of federal and state governments to address securities fraud and limits the recourse available to injured investors, the scope of SLUSA's preemption must be informed by a strong presumption against preemption.

B. In enacting SLUSA's preemption provision, Congress used a phrase with a settled meaning that is limited in scope to actions brought by purchasers or sellers of a covered security.

SLUSA provides that "[n]o . . . class action" based upon state statutory or common law may be brought in state or federal court by a private party alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security," 15 U.S.C. § 78bb(f)(1)(A), or the use of "any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security," *id.* § 78bb(f)(1)(B); *see also id.* § 77p(b) (amending the 1933 Act in the same manner).[1] SLUSA thus can preempt state-law actions alleging fraud only "in connection with the purchase or sale of a . . . security."

SLUSA does not define or otherwise explain the phrase "in connection with the purchase or sale of a . . . security." However, at the time SLUSA was enacted, this Court had construed the same language in § 10(b) of the 1934 Act and Securities and Exchange Commission ("SEC") Rule 10b-5.

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1. SLUSA also includes a removal provision, which states that "[a]ny covered class action brought in any State court involving a covered security . . . shall be removable to the Federal district court for the district in which the action is pending" and shall be subject to preemption. 15 U.S.C. § 78bb(f)(2).

See Blue Chip Stamps, 421 U.S. at 725. Section 10(b) makes it unlawful "[t]o use or employ, *in connection with the purchase or sale of [a] security* . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b) (emphasis added). Rule 10b-5 likewise forbids the use, "*in connection with the purchase or sale of [a] security*," of "any device, scheme, or artifice to defraud" or any other "act, practice, or course of business" that "operates . . . as a fraud or deceit." 17 C.F.R. § 240.10b-5 (emphasis added). Section 10(b) and Rule 10b-5 establish criminal and regulatory liability for fraud in connection with the purchase or sale of a security, but do not provide an express private right of action. *Blue Chip Stamps*, 421 U.S. at 729-30. However, courts have found an implied private right of action under § 10(b) and Rule 10b-5, and, over time, have defined the elements and scope of the right. *Id.* at 730; *see also Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) (private plaintiff may not maintain aiding and abetting suit under § 10(b)), *abrogated on other grounds by* Reform Act, § 104, 109 Stat. at 757 (codified at 15 U.S.C. § 78t); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (to maintain Rule 10b-5 action, plaintiff must allege that defendant acted with an "intent to deceive, manipulate, or defraud"); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (§ 10(b) and Rule 10b-5 litigation must be commenced within one year after the discovery of the violation and within three years after such violation occurs).

In *Blue Chip Stamps*, this Court considered the meaning of the phrase "in connection with the purchase or sale of a . . . security" in the context of a Rule 10b-5 private cause of action. The case involved a putative class of offerees who had alleged that the defendants issued an intentionally misleading prospectus in order to discourage purchases by the alleged class, so that the rejected shares could then be sold at a premium to the public. *Blue Chip Stamps*, 421 U.S. at 726-27. In the absence of any evidence that Congress, in enacting § 10(b), intended to extend

a private cause of action to individuals who had neither purchased nor sold stocks, the court declined to confer standing on such individuals to pursue a Rule 10b-5 action. *Id.* at 725-49.

Petitioner argues that because *Blue Chip Stamps* established a standing rule for private causes of action, the Court was not interpreting the phrase "in connection with the purchase or sale of a . . . security" and the *Blue Chip Stamps* limitation thus cannot be read into SLUSA's preemption provision. Petitioner's Br. at 29-30. However, while *Blue Chip Stamps* held that the plaintiff class lacked standing, it is incontrovertible that the Court's analysis and decision rested on its interpretation of the phrase "in connection with the purchase or sale of a . . . security." By the time Congress enacted SLUSA, that phrase thus had a longstanding, firmly established meaning, which excluded claims brought by nonpurchasers or nonsellers.[2] "When . . .

2. Relying on concurring opinions in *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258 (1992), Petitioner states that the Court "clearly" has stated that the purchaser/seller limitation is not a construction of the phrase "in connection with the purchase or sale of a . . . security." Petitioner's Br. at 3, 32. Both concurring opinions in *Holmes* concluded that the purchaser/seller limitation would not apply to suits brought under the Racketeer Influenced and Corrupt Organizations Act ("RICO"). Justice O'Connor noted that the purchaser/seller limitation "rests on the relationship between § 10(b) and other provisions of the securities laws . . . and the practical difficulties in granting standing in the absence of an executed transaction, . . . neither of which are relevant in the RICO context." *Holmes*, 503 U.S. at 284 (O'Connor, J., concurring in part and concurring in the judgment). Justice Scalia concluded that because *Blue Chip Stamps* involved "specification of the contours of a Rule 10b-5 action 'implied' (*i.e.*, created) by the Court itself," the limitation could not be read into RICO, which "contains no hint of such limitation." *Id.* at 289 (Scalia, J., concurring in the judgment). Unlike RICO, SLUSA deals explicitly and exclusively with the types of actions addressed in *Blue Chip Stamps*. Therefore, regardless of whether they are relevant in the RICO context, the *Blue Chip Stamps* limitation is relevant here, where Congress chose to use the same language to limit the scope of preemption for the same types of actions.

judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also National Labor Relations Bd. v. Amax Coal Co.*, 453 U.S. 322, 329 (1981) ("Where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.").

Moreover, while it was never a focus of debate, the *Blue Chip Stamps* limitation is mentioned in various parts of SLUSA's legislative history, further supporting the inference that Congress was aware of the purchaser/seller limitation on federal securities law claims when it enacted SLUSA. *See, e.g.*, 144 Cong. Rec. H10,775 (1998) (Joint Explanatory Statement of the Comm. of Conf.) ("there is no remedy under Section 10(b) for those who neither purchase nor sell securities") (citing *Blue Chip Stamps*, 421 U.S. at 734); *1998 Hearing on S. 1260, supra*, at 34 (statement of Richard W. Painter) ("a Federal plaintiff may not sue a person whose fraudulent statements induced her not to sell an overvalued security in her portfolio") (citing *Blue Chip Stamps*, 421 U.S. 723); *Securities Litigation Uniform Standards Act: Hearing Before the Subcomm. on Finance and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 77 (1998) (statement of Richard W. Painter) (same). By choosing to use language that it knew had been defined by this Court to exclude nonpurchasers and nonsellers in the context of a private right of action, Congress effectively incorporated the purchaser/seller limitation on the scope of SLUSA preemption.

Petitioner does not dispute that this Court's construction of the phrase "in connection with the purchase or sale of a . . . security," as used in § 10(b) and Rule 10b-5, is relevant in interpreting the same phrase as used in SLUSA, but argues that the phrase should not be interpreted to incorporate the *Blue Chip*

Stamps purchaser/seller limitation because this Court has interpreted this phrase more broadly in *United States v. O'Hagan*, 521 U.S. 642 (1997), and *SEC v. Zandford*, 535 U.S. 813 (2002). Petitioner's Br. at 24-29; *see also Kircher v. Putnam Funds Trust*, 403 F.3d 478, 483 (7th Cir. 2005) (*Blue Chip Stamps* "deals with private actions alone and does not restrict coverage of the statute and regulation"). Neither *O'Hagan* nor *Zandford* overrule or amend the *Blue Chip Stamps* holding or analysis in any way, nor do they set forth a different understanding of the scope of the phrase "in connection with the purchase or sale of a . . . security" as applied in the context of a private action. Even if these cases construed § 10(b) and Rule 10b-5's prohibition on fraud as allowing actions that are not limited to deception directed at or affecting identifiable purchasers or sellers, that prohibition is fully enforceable only by the government; private actions for damages are restricted to purchasers and sellers alone. Because SLUSA deals with precisely the category of actions subject to the purchaser/seller rule — *i.e.*, private causes of action for damages — and was enacted after *Blue Chip Stamps* was decided and applied by lower courts, it is "far more natural to suppose that Congress meant to import the settled standing rule" than to suppose that it meant to apply the fraud analysis from government cases. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 40 (2d Cir. 2005).[3]

Debate on both the Reform Act and SLUSA confirm that Congress understood that by remaining silent on the manner in which this Court had defined the scope of a private right of

3. *O'Hagan* is particularly inapposite. As the Court noted there, the manner in which the phrase "in connection with the purchase or sale of a . . . security" is construed in the context of private actions is irrelevant in the criminal context. *O'Hagan*, 521 U.S. at 664-65; *see also Holmes*, 503 U.S. at 280 (O'Connor, J., concurring in part and concurring in judgment) ("[T]he purchaser/seller standing requirement for private civil actions under § 10(b) and rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions.").

action under Rule 10b-5, the Reform Act and SLUSA implicitly incorporated any limitations imposed by the Court. For example, in *Lampf v. Gilbertson*, the Court held that the applicable statute of limitations for private rights of action under § 10(b) is one year after the plaintiff knew of the violation and in no event more than three years after the violation occurred. *Lampf*, 501 U.S. at 364. While the question of an appropriate statute of limitations was debated in hearings on both the Reform Act and SLUSA, the SLUSA Senate Committee Report notes that by not specifying a different statute of limitations, the legislation "left intact the shorter statute of limitations adopted by *Lampf*." S. Rep. No. 105-182, at 16-17, 20-21 (1998).

Similarly, in *Central Bank v. First Interstate Bank*, the Court held that § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act[,]" and does not reach those who aid or abet a person who commits a manipulative or deceptive act. *Central Bank*, 511 U.S. at 177-78. Again, whether the Reform Act or SLUSA should expand private rights of action to include actions for aiding and abetting was hotly contested during hearings on both pieces of legislation, but in the end, both statutes remained silent, followed *Central Bank*, and thus failed to restore aiding and abetting liability under § 10(b) and Rule 10b-5. *See* S. Rep. No. 105-182, *supra*, at 17-18 (noting that the Reform Act ignored recommendations to restore aiding and abetting liability for private investors and left the *Central Bank* holding in place).

SLUSA's proponents made it clear that the statute was a targeted approach to the specific problem of class actions migrating to state court after the Reform Act. *See, e.g.*, 143 Cong. Rec. S10,477 (1997) (statement of Sen. Dodd, co-sponsor) (SLUSA will "allow Congress to address this State litigation problem . . . in a very targeted and narrow way, essentially preempting only those class actions that have recently migrated to State court, while leaving traditional State court actions and procedures solidly in place"); *Securities Litigation*

Uniform Standards Act of 1997 – S. 1260: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 105th Cong. 7-8 (1997) (statement of Rep. Eshoo, co-sponsor of House bill) ("I would like to make clear that the bill is not a Federal power grab. This is returning to Federal courts the cases which, until the 1995 Reform Act, had always been heard in Federal courts. It is limited in scope . . . It's a targeted approach to a specific problem."); *Implementation of the Private Securities Litigation Reform Act of 1995: Hearing Before the Subcomm. on Finance and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. 39 (1997) (statement of Rep. Eshoo, co-sponsor) (stating that "[w]e're looking at some very, very narrow areas" and noting that the concern is "the migration of 10(b)(5) cases"). After *Blue Chip Stamps*, holder actions could be brought only in state court. Therefore, these actions were not subject to the Reform Act's procedural requirements, nor could they have migrated to state court after the Reform Act was enacted. Congress was aware of the *Blue Chip Stamps* limitation, chose to use the same language the Court found excluded holder claims, and did nothing to suggest it intended to reach these claims that were otherwise outside of SLUSA's targeted scope.

Petitioner asks the Court to assume that holder claims were a target of SLUSA because they are "among the most vexatious types of claims" and "least likely to present meritorious grounds for recovery of damages." Petitioner's Br. at 41. A number of States have themselves taken steps to limit holder claims. *See infra* at 18. And in any event, while policy concerns about the danger of vexatious litigation may provide support for denying a federal private right of action when state causes of action are available, *see Blue Chip Stamps*, 421 U.S. at 740, it is a wholly insufficient basis on which to find preemption.

If, as Petitioner suggests, frivolous holder actions are in fact impeding the purposes of the Reform Act or SLUSA, Congress can, as it has done in the past, address the problem through the legislative process. As the Court noted in *Blue Chip Stamps*, "[w]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.* at 749. Although Congress has reviewed the federal securities laws and explicitly considered the contours of the private cause of action, it has remained silent about whether the cause of action extends to nonpurchasers and nonsellers. Therefore, judicial interpretations of the private right of action control, and the Second Circuit correctly held that SLUSA does not preempt class actions brought solely on behalf of persons fraudulently induced to hold or retain a security.[4]

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4. A majority of the courts that have considered the issue agree. *See, e.g., Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1345 (11th Cir. 2002) ("SLUSA does *not* apply to claims dealing *solely* with the retention of securities, rather than with purchase or sale" but finding allegations in this case not limited to retention of securities) (emphasis in original); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 598 (8th Cir. 2002) (SLUSA does not make class actions on behalf of "nonsellers" and "nonpurchasers" removable to federal court); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 594-95 (W.D. Tex. 2001) (SLUSA does not apply where plaintiff seeks damages for being fraudulently induced to hold a stock); *Shaw v. Charles Schwab & Co.*, 128 F. Supp. 2d 1270, 1272-74 (C.D. Cal. 2001) (SLUSA does not bar a state fraud claim where the alleged fraud caused plaintiffs to choose a brokerage firm not to buy or sell a security); *Abada v. Charles Schwab & Co.*, 127 F. Supp. 2d 1101, 1103 (S.D. Cal. 2000) (SLUSA does not preempt claim where defendant's alleged conduct did not involve the trading of a security); *Gordon v. Buntrock*, No. 00 CV 303 (JFH), 2000 U.S. Dist. LEXIS 5977, 2000 WL 556763, at *4 (N.D. Ill. Apr. 28, 2000) (Memorandum Opinion and Order) (plaintiff's claim was not removable under SLUSA because complaint did not allege that defendant's misrepresentations were made in connection with the

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II. Construing SLUSA to allow state-law remedies for holder claims strikes an appropriate balance between protecting investors from fraud and furthering Congress's purpose of promoting consistent and efficient markets.

Federal securities law strikes a balance between uniform regulation of national markets and preservation of areas "traditionally relegated to state law." *Santa Fe Indus. v. Green*, 430 U.S. 462, 478-80 (1977) (internal quotation marks and citation omitted) (discussing principles of federalism and holding that claims challenging "internal corporate mismanagement" are not actionable under § 10(b))). That balance is appropriately struck here by construing SLUSA as continuing to allow injured investors to seek recourse for holder claims under state law, while preempting class actions that had migrated to state court after passage of the Reform Act.

First, investors induced to hold a security are at least as vulnerable to fraud as those induced to purchase or sell a security. Many victims of recent corporate frauds are those who were induced to hold their shares while insiders who knew the true state of the company sold at inflated prices. *See, e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 336 F. Supp. 2d 310, 318-23 (S.D.N.Y. 2004) (analyzing holder claims brought against WorldCom defendants); *In re WorldCom, Inc. Sec. Litig.*, 382 F. Supp. 2d 549, 558-60 (S.D.N.Y. 2005) (same); *Small*, 30 Cal. 4th 167, 181, 65 P.3d at 1263-64 (citing examples).

Second, and perhaps more important, if SLUSA is construed to preempt actions brought by investors who neither purchased

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purchase or sale of a covered security); *Hines v. ESC Strategic Funds, Inc.*, No. 3:99-0530 (AAT), 1999 U.S. Dist. LEXIS 15790, 1999 WL 1705503, at *5-6 (M.D. Tenn. Sept. 17, 1999) (holding that SLUSA does not apply to state-law claims for breach of fiduciary duty that occurred after the sale of the securities in question).

nor sold securities during the relevant period, SLUSA would preempt any state class action these investors might have, and because they were not induced to purchase or sell a security, they would also lack standing to bring a federal action under *Blue Chip Stamps*. While plaintiffs would remain free to bring state-law actions for securities fraud, because of the nature of holder claims and the relatively small amount of damages typically suffered by one person, individual plaintiffs will generally lack the resources and incentive to bring individual actions. *See Amchem Prods. v. Windsor*, 521 U.S. 591, 617 (1997) ("'The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.'") (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (1997)). Similarly, state government action is not sufficient by itself. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 31 (1997) ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action."); *Securities Litigation Abuses: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 10 (1997) (Opening Statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission) ("The Commission continues to believe that private actions provide valuable and necessary additional deterrence against the temptation to commit securities fraud, thereby supplementing the Commission's own limited enforcement activities.").

There is no indication that Congress intended such a draconian result. In *Blue Chip Stamps*, the Court concluded that any harsh effects caused by restricting private actions to purchasers and sellers would be mitigated "to the extent that remedies are available to nonpurchasers and nonsellers under state law." *Blue Chip Stamps*, 421 U.S. at 738, n.9. In the Court's view, the considerations that justified denying investors a federal

forum for their holder claims did not warrant denying them relief altogether. To the contrary, it would be "undesirable" to eliminate a federal cause of action if no other avenue for redress existed. *Id.* at 738-39. As the Second Circuit concluded, "SLUSA's wholesale importation of the language that gave rise to this balancing judgment must therefore be presumed to represent a ratification of that judgment." *Dabit*, 395 F.3d at 40 (citing *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982); *Calif. Public Employees' Ret. Sys. v. WorldCom, Inc.*, 368 F.3d 86, 105 & n.17 (2d Cir. 2004)).[5]

Nor does anything in SLUSA's legislative history suggest that Congress rejected this longstanding federal-state balance of power. Indeed, SLUSA's proponents indicated that it would not take away rights of investors who had been harmed. *See, e.g.*, 144 Cong. Rec. H6,058 (1998) (statement of Rep. Tauzin) ("Have we taken away any legitimate rights of people who have been harmed? No."). For example, in supporting the Conference Report on the bill that would become SLUSA, one of the bill's co-sponsors assured potential opponents of the bill that "[i]f there is intentional fraud, there is nothing in this legislation or in the Reform Act to prevent those cases from proceeding." 144 Cong. Rec. H11,020 (1998) (statement of Rep. Bliley). Even if Congress recognized that the pleading requirements imposed by SLUSA and the Reform Act would make some forms of relief more difficult for plaintiffs to obtain, it demonstrated no intent to completely deprive a group of injured investors of a cause of action.

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5. Nor does any possible concern with uniformity justify striking a different balance. As this Court has held, such an interest "is not unyielding" and "does not justify the displacement of state common-law remedies that compensate accident victims and their families." *Sprietsma v. Mercury Marine*, 537 U.S. 51, 70 (2002); *see also Medtronic*, 518 U.S. at 495 (traditional state-law damages remedies provide additional incentives for manufacturers to comply with federal manufacturing and labeling requirements).

State-law remedies for holder claims further Congress's objectives by compensating victims and creating additional incentives for corporations to comply with securities laws. At the same time, there is no evidence that allowing States to make remedies available for holder claims has led or will lead to a flood of frivolous strike suits. Indeed, States are limiting this risk themselves by imposing heightened pleading requirements or other limitations on holder claims. *See, e.g.*, *Small*, 30 Cal. 4th 167, 183-85, 65 P.3d at 1265-66 (California recognizes causes of action for fraud and negligent misrepresentation where plaintiff retains stock in reliance on defendant's false representation, but requires such claims to be pled with specificity); *see also Rogers v. Cisco Systems*, 268 F. Supp. 2d 1305, 1311-12 (N.D. Fla. 2003) (applying Florida law and imposing heightened pleading standards on holder claims); *Gutman v. Howard Savings Bank*, 748 F. Supp. 254, 263 (D.N.J. 1990) (under New York and New Jersey law, a "plaintiff may state a common law fraud claim against a defendant whose misrepresentations caused plaintiff to hold securities which plaintiff otherwise would have sold" where defendant's alleged misrepresentations were made in direct dealings with plaintiff). It is thus unnecessary to expand SLUSA's preemption — and further displace States' authority — in order to further Congress's objectives.

CONCLUSION

For the foregoing reasons, this Court should affirm the decision of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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No. 04-1371

In the Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC,
Petitioner.

V.

SHADI DABIT ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF PACIFIC LIFE INSURANCE COMPANY AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF THE *AMICUS CURIAE*[1]

A key legal question to be decided in this case significantly affects *amicus'* interests. Pacific Life Insurance Company ("Pacific Life") offers variable annuity contracts that permit contract holders to allocate their premium payment(s) to investments, including mutual funds. These are securities to which the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") applies. Pacific Life was named as defendant in class action litigation filed in Madison County, Illinois. The case—*Spurgeon v. Pacific Life Insurance Company*—was one of the cases consolidated and decided in *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005).

It was with respect to Pacific Life that the Seventh Circuit reached the question of whether the preemptive scope of SLUSA is limited by the purchaser-seller requirement recognized in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The Seventh Circuit's decision that the purchaser-seller requirement does not limit the scope of SLUSA preemption was the basis of its ruling that the state law claims against Pacific Life are preempted. *Kircher*, 403 F.3d at 483-84. A petition for certiorari in *Kircher* is currently before this Court. In addition, Mr. Spurgeon's appeal from the decision of the United States District Court for the Southern District of Illinois on remand is pending in the Seventh Circuit.

The question presented in the instant case involves the same determination—whether the purchaser-seller limitation was incorporated into SLUSA. *Amicus*, therefore, has a significant and immediate interest in the question presented in this case and its views can assist the Court in resolving this question.

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[1] The parties have consented to the submission of this brief. Their letters of consent have been filed with the Clerk of this Court. Pursuant to Supreme Court Rule 37.6, no counsel for a party authored the brief in whole or in part and no person or entity other than Pacific Life or its counsel made a monetary contribution to the preparation or submission of this brief.

SUMMARY OF ARGUMENT

Analytically, this case presents two questions. The question presented requires a determination of whether the purchaser-seller requirement recognized by this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), was incorporated into SLUSA by Congress, and thereby imposes a limit on SLUSA's preemptive reach.[2] The application to a particular case requires a determination whether SLUSA preemption reaches the misconduct alleged in the case—*i.e.*, whether it is sufficiently related to securities transactions to satisfy the statute's "in connection with" requirement.

Blue Chip Stamps and this Court's subsequent decisions establish that the purchaser-seller requirement was not found in Section 10(b)'s statutory text and, therefore, was not incorporated into SLUSA when Congress borrowed Section 10(b) language in drafting SLUSA. Pts. I, II. The second question requires a case-by-case determination. If the Court reaches that determination in the instant case, *amicus* urges the Court to consider additional contexts in which the relationship between alleged misconduct and securities transactions is presented—including claims arising from market-timed securities transactions—and to frame any determination in the instant case with those situations in mind. Pt. III.

ARGUMENT

I. THE LANGUAGE CONGRESS BORROWED FOR SLUSA DID NOT INCLUDE THE *BLUE CHIP STAMPS* PURCHASER-SELLER LIMITATION.

Blue Chip Stamps and its progeny offer no support for the Second Circuit's conclusion that Congress limited the

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[2] SLUSA, P.L. 105-353, 112 Stat. 3227, is *codified at* both 15 U.S.C. §§ 77p and 78bb(f) (amending, respectively, the Securities Act of 1933 and the Securities Exchange Act of 1934).

scope of SLUSA preemption to actions brought by purchasers or sellers when it borrowed the "in connection with" language from Section 10(b) of the Securities Exchange Act of 1934, or the identical language in Rule 10b-5, to define SLUSA preemption. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. This Court did not find the purchaser-seller requirement it recognized in *Blue Chip Stamps* in the "in connection with" language of Section 10(b) or Rule 10b-5. The Court fashioned the requirement as a permissible policy-driven limit on the private right of action that courts had already fashioned. *Blue Chip Stamps* made clear that the limitation was not found in the statutory text of 10(b) or the regulatory text of Rule 10b-5, and opinions from this Court and individual justices have repeatedly confirmed this understanding.

A. *Blue Chip Stamps* Repeatedly Explains That the Purchaser-Seller Limitation Is Not An Interpretation of Section 10(b)'s "In Connection With" Provision. B.

Blue Chip Stamps, in discussing its decision to adopt the purchaser-seller requirement, emphasized that it had not found the requirement in Section 10(b) itself or in SEC Rule 10b-5, much less their "in connection with the purchase or sale of any security" language. Rather, the Court concluded that neither Congress nor the SEC had expressly provided or contemplated a private right of action under Section 10(b) or Rule 10b-5, and that "[n]o language in either of those provisions *speaks at all* to the contours of a private cause of action for their violation." *Blue Chip Stamps*, 421 U.S. at 749 (emphasis added). Rather, the Court explained, "We are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." *Id.*

The Court reiterated, in announcing the purchaser-seller requirement as a limitation on this private right of

action, that it was not interpreting statutory text. "[W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 737. Rather, the Court explained, "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." *Id.*

The Court considered the statutory provision, its legislative history and related provisions to determine that "in fashioning substantive law," *id.* at 742, it was not promulgating a judge-made restriction that was inconsistent with the statute. Its review reassured the Court that the requirement was consistent with *other* provisions in which Congress expressly provided for a private right of action, *id.* at 736, and what it could "glean from the intent of Congress," *id.* at 749, and that Congress itself recognized the potential for nuisance suits in 1934, *id.* at 740-41. Therefore, it concluded that imposing the limitation was permissible. *Id.* at 749.

1. The requirement was founded upon policy considerations.

The Court justified the purchaser-seller limitation by considering its own view of the wisdom of such a limitation. The Court recognized that "if Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted." *Id.* at 748. However, the Court explained, Congress had not done so. Thus, it concluded that "we are free to weigh" what it termed "considerations of policy." *Id.* at 749.

The considerations that weighed most heavily—"purely as a matter of policy"—were: (a) the "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general," *id.* at 739, (b) the

recognition that "[t]he very pendency of the lawsuit may frustrate or delay normal business activity of the defendant" leading to settlements "out of any proportion to its prospect of success at trial," *id.* at 740, and (c) "[t]he potential for possible abuse of the liberal discovery provisions" permitting "a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value," *id.* at 741.

By adopting the purchaser-seller requirement, the Court strove to curb nuisance suits based on "hazy issues of historical fact," *id.* at 743, and "the possibility that unduly expansive imposition of civil liability will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers," *id.* at 739 (citation and quotation omitted). Having given these "practical factors . . . a good deal of weight," the Court determined "it is a sound rule and should be followed." *Id.* at 749.

2. The Court recognized the limitation was narrower than the statute.

Moreover, *Blue Chip Stamps* expressly recognized that its purchaser-seller requirement was not co-extensive with the statute, but narrower, and that the requirement would therefore preclude suits that, in fact, *met* the statutory requirement that a suit be "in connection with the purchase or sale of a security." 15 U.S.C. § 78j(b). In considering the policy implications of adopting the limitation, the Court noted that one of the categories of suits that would be precluded by a purchaser-seller requirement would be suits by shareholders whose shares lost value "due to corporate or insider activities in connection with the purchase or sale of securities *which violate Rule 10b-5.*" 421 U.S. at 738 (emphasis added). Later in the opinion, the Court recognized again that the limitation "undoubtedly excludes plaintiffs who have in fact been damaged by violations of

Rule 10b-5." *Id.* at 743. If the Second Circuit were correct that the purchaser-seller requirement is an interpretation of Section 10(b)'s text, *i.e.*, a requirement imposed by the statute, the requirement would preclude exactly the same actions that the statute itself precludes—not *additional* ones.

In addition, if the requirement were an interpretation of statutory text, it would necessarily apply equally to suits brought by the SEC and suits brought by private plaintiffs. Section 10(b) provides the definition of the conduct that constitutes a violation. Nothing in the text distinguishes between misconduct the SEC may use its enforcement powers to punish and misconduct for which a private party may recover. Congress provided only one definition. *Blue Chip Stamps* expressly recognized again that this one definition—Section 10(b) itself—did not supply the purchaser-seller limitation when it clarified that the judicially-crafted requirement "imposes no limitation on the standing of the SEC to bring actions" under Section 10(b) or Rule 10b-5. *Id.* at 752 n.14.

B. This Court Has Repeatedly Confirmed That the Purchaser-Seller Limitation Is Not Found in the Statutory Text.

Since *Blue Chip Stamps*, opinions by the Court and individual justices have repeatedly confirmed that the purchaser-seller requirement is a judicially-fashioned restriction and not a requirement imposed by the statute. As Justice O'Connor succinctly noted in *Holmes v. Securities Investor Protection Corp.*, "The purchaser/seller standing limitation in Rule 10b-5 damages actions . . . does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.' " 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and concurring in the judgment). Similarly, *United States v. O'Hagan*, 521 U.S. 642, 664 (1997), confirmed that *Blue Chip Stamps* had

adopted the purchaser-seller requirement "because of 'policy considerations.' "

In *Musick, Peeler & Garrett v. Employers Insurance of Wausau,* the Court cited *Blue Chip Stamps* as "recognizing the authority of federal courts to define the contours of a private cause of action under Rule 10b-5," in the *absence* of "congressional enactment." 508 U.S. 286, 293 (1993) (quotation omitted). The Court noted that Congress had "made no attempt to define the precise contours of the private cause of action under § 10(b)" and, therefore, "had no occasion to address how to limit, compute, or allocate liability arising from it." *Id.* at 295.

Musick also observed that Congress had apparently chosen to continue to avoid "entangling" itself in the formulation of rules defining the contours of the private cause of action under § 10(b). *Id.* at 294. *Musick* interpreted Congress' enactment of legislation limiting the retroactive effect of the Court's decision as to the applicable statute of limitations for Rule 10b-5 actions, as an "acknowledgment of the 10b-5 [private] action, without any further expression of legislative intent to define it," and a decision to leave rules delineating private Rule 10b-5 actions up to the courts. *Id.* It concluded, "That task, it would appear, Congress has left to us." *Id. Musick,* as other decisions before it, continued in the *Blue Chip Stamps* tradition by fashioning an additional judge-made rule governing private actions under Section 10(b) and Rule 10b-5.

Central Bank v. First Interstate Bank, 511 U.S. 164, 172 (1994), reiterated the same understanding. The Court noted that its decisions with respect to Section 10(b) and Rule 10b-5 actions fell into two categories. With respect to the first – determining "the scope of conduct prohibited by § 10(b)—the Court stated that "the text of the statute controls our decision." *Id.* at 173. With respect to the second—"determining the elements of the 10b-5 private liability scheme"—*Central Bank* explained that the Court

has had to infer what Congress might have done had it considered the question. *Id.* This was because "Congress did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme." *Id.*

Central Bank lists *Blue Chip Stamps* as a decision within the second category, a decision in which Section 10(b)'s statutory text did not control the decision because Congress had provided no "guidance." *Id.* at 172. Because the purchaser-seller requirement recognized in *Blue Chip Stamps* is not imposed by Section 10(b)'s "in connection with" language, and this Court had long made clear that it is not, Congress' borrowing of that language for SLUSA cannot be understood as evidencing an intention to import the purchaser-seller limitation into its definition of SLUSA's preemptive reach. Indeed, it would be ironic if *Blue Chips Stamps'* limitation, which precludes the private securities actions this Court thought most likely to be vexatious, were the mechanism for limiting Congress' efforts to preclude state securities class actions it found vexatious and abusive.

II. SLUSA'S "IN CONNECTION WITH" LANGUAGE REQUIRES ONLY THAT THE MISCONDUCT INVOLVE SECURITIES TRANSACTIONS.

Section 10(b)'s and Rule 10b-5's "in connection with" language has consistently been read to reach conduct connected to *anyone's* securities transactions, rather than limited to conduct connected to *plaintiffs'* purchases or sales. SLUSA's use of that language, without providing for a different meaning, precludes a narrower construction of SLUSA's "in connection with" language. That textual reading is also supported by the statute's purpose and legislative history.

A. The Borrowed Language Defines Claims In Which the Alleged Misconduct Coincides With Securities Transactions.

The established judicial construction of Section 10(b)'s and Rule 10b-5's "in connection with" requirement is that it requires only that the alleged fraud coincide with securities transactions. It does not require that the plaintiffs themselves purchased or sold the securities at issue or, therefore, that plaintiffs in a class action purchased the securities during the class period. Section "10(b) bans the use of any deceptive device in the 'sale' of any security by *'any person.'* " *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10 (1971) (emphasis added).

Thus, *United States v. O'Hagan*, 521 U.S. 642, 656 (1997), ruled that Section 10(b)'s "in connection with" requirement was satisfied by the *defendant's* purchase of securities. The requirement was satisfied because attorney O'Hagan's breach of duty to his firm's client coincided with his *own* purchases of securities. *Id.* The Court explained that the "provision, as written, does not confine its coverage to deception of a purchaser or seller of securities." *Id.* at 651. Section 10(b) may be violated "even though the person or entity defrauded is not the other party to the trade." *Id.* at 656.

Similarly, in *SEC v. Zandford*, 535 U.S. 813, 822 (2002), the Court ruled that a broker's sale of his client's securities and theft of the proceeds, without the client's knowledge, met the "in connection with" requirement because: "It is enough that the scheme to defraud and the sale of securities coincide." *See also Carpenter v. United States*, 484 U.S. 19, 24 (1987) (affirming, by divided vote, the conviction under Section 10(b) and Rule 10b-5 of a newspaper columnist, based on securities trades by his *co-participants*, because the columnist had breached his duty to his newspaper by passing on confidential information, even though "the victim of the fraud, the Journal, was not a buyer or seller of the stocks traded in or otherwise a market participant").

Moreover, in these cases, as in other enforcement proceedings under Section 10(b) and Rule 10b-5, none of the securities transactions found to meet the "in connection with" requirement were purchases or sales by the *plaintiff*. In such proceedings, the plaintiff is a government agency. Although, in each case, this Court required that the misconduct alleged must be "in connection with" securities transactions, it has never required that the plaintiff be the purchaser or seller. *See, e.g., United States v. Naftalin,* 441 U.S. 768 (1979).

B. The Statutory Text Precludes Adding A Purchaser-Seller Restriction.

When Congress borrowed Section 10(b)'s "in connection with" language for SLUSA, it intended the phrase to mean for SLUSA purposes what it means for Section 10(b) and Rule 10b-5 purposes. *See, e.g., Bragdon v. Abbott,* 524 U.S. 624, 632 (1998) ("Congress' repetition of a well-established term carries the implication that Congress intended the term to be construed in accordance with pre-existing . . . interpretations."); *Lorillard v. Pons,* 434 U.S. 575, 581 (1978) (Congress "can be presumed to have had knowledge of the interpretation given to the incorporated law."). Congress is understood to have "adopted" the pre-existing interpretations unless it provides otherwise. *See Keene Corp. v. United States,* 508 U.S. 200, 212 (1993).[3]

Thus, the meaning of Section 10(b)'s "in connection with" language provides its meaning for SLUSA. All six of the Courts of Appeals to address the question have reached

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[3] Here, the presumption is particularly appropriate because the "old" and "new" laws are sections of both the same and related statutes. *See, e.g., Gustafson v. Alloyd Co.,* 513 U.S. 561, 570 (1995) (adhering to "the normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning") (quotations omitted); *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 229-30 (1993) (relying on long-settled meaning of Clayton Act language to interpret identical phrase in Robinson-Patman Act).

the same conclusion. *See Kircher*, 403 F.3d at 482 (noting that "[e]very court of appeals to encounter SLUSA has held that its language has the same scope as its antecedent in Rule 10b-5") (citing decisions from the Second, Third, Eighth, Ninth and Eleventh Circuits and adding the Seventh Circuit to that consensus).

As discussed above, the meaning of Section 10(b)'s "in connection with" requirement—and, thus, SLUSA's—is that the misconduct alleged must be in connection with *someone's* securities transactions. It need not be in connection with plaintiffs' transactions, much less plaintiffs' transactions during the class period. *See, supra*, Pt. II.A.

Nothing in SLUSA's text offers a toehold for narrowing SLUSA's preemptive reach. Congress was certainly aware of the long-recognized judicially-imposed purchaser-seller requirement on private suits under Section 10(b) and Rule 10b-5, and "knew how to impose [a purchaser-seller requirement] when it chose to do so." *Central Bank*, 511 U.S. at 176. Only ten years before enacting SLUSA, Congress provided a private right of action to recover losses caused by insider trading and expressly limited such suits to contemporaneous purchasers and sellers. *See* Insider Trading and Securities Enforcement Act of 1988, P.L. 100-704, 102 Stat. 4677, 4680-81, *codified at* 15 U.S.C. § 78t-1(a) (confining application to "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class").

Congress did not adopt this language, or *any* language, to similarly limit SLUSA's reach. Had Congress intended to limit SLUSA's application to suits alleging misconduct in connection with plaintiffs' securities transactions, it could have done so by changing only one word. It could have drafted the requirement to provide: "in connection with *plaintiff's* purchase or sale of a covered security" instead of *"the"* purchase or sale. It did not do so.

Congress could also have incorporated such a limitation in SLUSA by defining "covered class actions" to include only lawsuits brought by the purchasers or sellers of the securities. Again, Congress did not do so. Congress could have included—in the long list of carefully delineated exceptions that Congress *did* provide – an express exception for suits under state law brought by non-purchaser-sellers. *See* 15 U.S.C. §§ 78bb(f)(3), (f)(4), (f)(5)(C). But Congress did not do that either.

Congress' use of language with a well-settled meaning, without including any provision narrowing that meaning, precludes addition of a narrowing construct. Courts "begin with the understanding that Congress says in a statute what it means and means in a statute what it says there." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (quotation omitted). When, as here, "the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms." *Id.* (quotations omitted).

C. Applying the Settled Meaning of "In Connection With" to SLUSA Preemption Would Not Lead to Absurd Results.

Literal application of the "in connection with" provision is not even *outside* Congress' purposes, much less "demonstrably at odds" with them. *See Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982) (noting that courts may override statutory language only in the rare case where "the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters").

Rather, it would affirmatively further the purposes for which Congress enacted SLUSA, by helping to ensure that securities lawsuits are able to impose costs on the securities markets only if they are sufficiently meritorious to survive the gatekeeping mechanisms Congress has chosen to rely

on. SLUSA was intended to make "Federal court the exclusive venue for most securities class action lawsuits." H. R. Conf. Rep. No. 105-803, at 13 (1998) ("Conf. Rep."). "The legislation is designed to protect the interests of shareholders and employees of public companies that are the target of meritless 'strike' suits. The purpose of these strike suits is to extract a sizeable settlement from companies that are forced to settle, regardless of the lack of merits of the suits, simply to avoid the potentially bankrupting expense of litigating." *Id.* Applying the terms of the statute furthers these purposes by requiring private class action plaintiffs who complain of being deceived to bring federal securities fraud suits subject to federal procedural safeguards, and private class action plaintiffs who complain of corporate mismanagement to bring derivative suits, which are expressly exempted from SLUSA preemption but subject to state law procedural safeguards.

Although the primary impetus for SLUSA was an interest in staunching the increasing flow of securities class actions brought in state courts to avoid the strictures Congress had imposed three years earlier in the PSLRA,[4] the statute Congress enacted is broader. *See* SLUSA, 112 Stat. at 3227, 3228, 3230. Indeed, it is commonplace for Congress to have focused on the need to respond to a particular problem but to enact broader legislation. *See Brogan v. United States,* 522 U.S. 398, 403 (1998) (recognizing "the reality that the reach of a statute often exceeds the precise evil to be eliminated"). When Congress enacts broader legislation, as this Court has repeatedly explained, "it is not, and cannot be, our practice to restrict the unqualified language of a statute to the particular evil that Congress was trying to remedy." *Id. See also Engine Mfrs. Ass'n v. S. Coast Air Quality Mgmt.,* 541 U.S. 246, 253-55 (2004) (applying federal statute to preempt state restrictions on vehicle purchasers, although Congress' expressed focus

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[4] The Private Securities Litigation Reform Act of 1995, P.L. 104-67, 109 Stat. 743, 758, *codified at* 15 U.S.C. §§ 77z-1, 78u-4.

was on eliminating the restrictions on manufacturers); *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 245-49 (1989) (recognizing that the language of the RICO statute reaches far more than organized crime and declining to narrow that reach).

Moreover, Congress was well aware that SLUSA precluded a wider range of state law securities suits than those that could have been filed in federal court but were filed in state court to avoid the PSLRA. Some members of Congress, consumer organizations, and law professors had argued strenuously during the legislative process that SLUSA would deprive investors of any remedy at all in many circumstances and should be amended to avoid that. Senators Sarbanes, Bryan and Johnson had filed a separate statement to accompany the committee report from the Senate, stressing that "in too many cases, investors will be left without any effective remedies at all." S. Rep. 105-182, at 11 (1998) (Additional views of Senators Sarbanes, Bryan and Johnson). The statement emphasized that SLUSA would withdraw a number of protections investors had enjoyed under state law, mentioning specifically the ability to impose aiding and abetting liability and longer statutes of limitation. *Id.* at 20-22.

Their argument for amending SLUSA to avoid such broad preemption did not prevail. In addition to closing the PSLRA loophole, the majority was concerned more generally with the harmful effects of subjecting nationally traded securities to state law in private class actions. The PSLRA itself was enacted in reaction to "abuse in private securities lawsuits," which Congress determined was undermining the "integrity of American markets . . . by those who seek to line their own pockets by bringing abusive and meritless suits." H.R. Conf. Rep. No. 104-369 at 31 (1995). But, in the three years following enactment of the PSLRA, Congress' efforts to prevent abusive suits was increasingly thwarted by savvy litigators filing actions against securities companies under state law. 112 Stat. at 3227.

Thus, the Senate Committee noted that "state-court class actions involving nationally traded securities were virtually unknown prior to the [PSLRA, but] they are brought with some frequency now." S. Rep. No. 105-182, at 4 (1998). It expressed concern that "this state class-action trend has . . . created a ripple-effect that has inhibited small, high growth companies in their efforts to raise capital, and has damaged the overall efficiency of our capital markets." *Id.*

After weighing states' rights and federalism interests, it "found the interest in promoting efficient national markets to be the more convincing and compelling consideration in this context," *id.*, because "fraudulent and abusive securities class action litigation distorts the efficient operation of those markets and the optimal allocation of available capital," *id.* at 5. The Conference Committee similarly expressed the concern of majorities in both houses of Congress with plaintiffs' lawyers' "filing frivolous and speculative lawsuits in State court," and "a single state [being able to] impose the risks and costs of its peculiar litigation system on all national issuers." Conf. Rep. at 15.

Whether Congress specifically anticipated every instance in which SLUSA would preempt a state law action that—in fact or as drafted—could not be brought under federal law has no bearing. *See Griffin*, 458 U.S. at 576 (imposing the terms of a statute as written, notwithstanding its conclusion that Congress had not precisely envisioned the result, and noting many other statutes that had been applied as written regardless of whether Congress had anticipated the situation to which they were applied). "[T]he fact that a statute can be applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth." *Pa. Dep't of Corr. v. Yeskey*, 524 U.S. 206, 212 (1998) (quotation omitted).

Thus, whether or not the current rash of securities lawsuits, artfully drafted as state law actions, had been expressly anticipated by Congress, the statute Congress

enacted plainly, and properly, covers them. That Congress' purposes are furthered by SLUSA's preemption of all actions it reaches, regardless of whether the plaintiffs purchased or sold securities, "only underscores [the courts'] duty to refrain from reading a phrase into the statute when Congress has left it out." *Keene*, 508 U.S. at 208.

D. The Second Circuit's View Is Based on a Misreading of the Statutory Text.

The Second Circuit's conclusion in the instant case—that the purchaser-seller requirement is contained in the "in connection with" language of Section 10(b), and therefore in SLUSA—strayed too far from the statutory text and misread *Blue Chip Stamps*. *See* Pet. App. 52a. The court below offered no explanation as to how the text of Section 10(b) could have one meaning when applied to a case brought by the SEC and another when applied to a case brought by a private plaintiff. The court's conclusion that the SEC could bring a Section 10(b) claim as long as *someone* buys or sells the security during the period of allegedly fraudulent conduct, *id.* at 24a, should have resolved the *statute's* application to all potential plaintiffs. Its reliance upon *Blue Chip Stamps* to supply controlling precedent, in the absence of textual analysis, is misplaced. As discussed above, *Blue Chip Stamps* did not rule that Section 10(b), much less its "in connection with" provision, supplied the purchaser-seller requirement; rather, the Court explained repeatedly that it did not. *See, supra*, Pt. I.

None of the ancillary arguments relied on by the court below apply. Its focus on whether Congress, in enacting SLUSA, had expressly indicated that it intended to reach suits by non-purchasers/non-sellers is backwards. *See* Pet. App. 21a, 27a, 31a. Congress had already indicated it intended to reach such suits by borrowing language that had long been read to reach such suits. The appropriate question would have been whether Congress had expressly indicated that it intended to *exclude* suits by non-purchasers/non-sellers because courts may only disregard statutory

text if there is "something to make plain the intent of Congress that the letter of the statute is not to prevail." *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). *Accord Tenn. Valley Auth. v. Hill*, 437 U.S. 153, 188 n.33 (1978). There was not. *See, supra*, Pts. II.B&C.

The Second Circuit's reliance on the presumption against preemption is also inapposite. See Pet. App. 30a-31a. Congress provided an *express* preemption provision in SLUSA, leaving "the task of statutory construction . . . in the first instance [to] focus on the plain wording of the clause, which necessarily contains the best evidence of Congress' preemptive intent." *CSX Trans., Inc. v. Easterwood*, 507 U.S. 658, 664 (1993).

Finally, the court below cannot derive support from *Blue Chip Stamps'* conclusion that the purchaser-seller restriction it fashioned would be counterbalanced by the existence of remedies under state law. *See* Pet. App. 29a-30a. *Blue Chip Stamps* noted such remedies in a footnote in its consideration of the practical policies weighing in favor of and against adopting such a limitation on private securities actions. The Court's weighing of the practical implications of a judge-made restriction under consideration has no force in *this* context. Congress has spoken since *Blue Chip Stamps'* policy discussion. It enacted a statute that preempts state law private securities class actions, using language long understood to reach actions by non-purchasers/non-sellers. Therefore, "[t]he issue . . . is not whether [permitting plaintiffs to bring actions under state law that may not be maintained by them under federal law] is good policy but whether [it] is covered by the statute." *Central Bank*, 511 U.S. at 177. Thus, even if the Second Circuit viewed such preemption as unwise or unfair, it may not "substitute its policy judgment for that of Congress." *Hodel v. Indiana*, 452 U.S. 314, 331 (1981).

In sum, SLUSA's "in connection with" requirement, like Section 10(b)'s, is met if the alleged misrepresentations,

omissions or manipulative conduct is connected to *someone's* securities transactions.

III. APPLICATION OF SLUSA'S "IN CONNECTION WITH" REQUIREMENT TO INDIVIDUAL CASES.

With respect to whether alleged misconduct is connected to someone's securities transactions in a specific case, this Court has repeatedly held, in interpreting Section 10(b), that "in connection with" should be read broadly and flexibiy, not technically and restrictively. *Zandford,* 535 U.S. at 819. In many contexts, such as the market timing class actions, a broad and flexible reading of the "in connection with" requirement is not even needed to find the requirement met. *Amicus* presents its view of SLUSA's application to market-timing class actions in order to inform this Court's framing of its decision, if it reaches the application of SLUSA's "in connection with" requirement to the instant case.

A. The Market-Timing Class Action Allegations

Many of the market-timing class actions brought over the last two years allege that variable annuity and mutual fund companies facilitated transactions by arbitrageurs that diluted the value of shares owned by longer-term holders, including plaintiffs, by the manner in which they are alleged to have set share prices. Mutual funds, and the subaccounts by which variable annuity contract-holders invest in them, set share prices once a day as of the close of the New York Stock Exchange. These class actions allege that the companies set share prices for these funds and subaccounts based on the most recently available market value for each security. For securities traded in the United States, the most recently available market value is a current price. For securities traded on foreign stock exchanges, the most recently available market value is five to fifteen hours old, because they operate in different time zones.

The class actions allege that arbitrageurs can predict whether foreign securities will rise or fall, based on what has happened in the U.S. markets while the foreign exchanges were closed and other indices, and that the arbitrageurs can therefore time purchases and sales of shares in fund portfolios that include foreign securities to take advantage of the allegedly "stale" pricing. The actions further allege that, by doing so, these market-timers reap profits that would otherwise belong to long-term investors and avoid losses that are left to the long-term investors. They further allege that the companies facilitated the market-timers' transactions and thereby breached duties to their long-term investors by exposing them to dilution of the value of their securities. In some complaints, the class actions allege that the companies failed to disclose that the pricing was "stale," that arbitrage was a risk, and that it would lower the value of securities held long-term.

B. "In Connection With" Transactions By Market Timers

The first way in which these market-timing class actions meet SLUSA's "in connection with" requirement is by alleging that the variable annuity and mutual fund companies breached their duties by facilitating purchases and sales of covered securities by market timers. The plaintiffs specifically allege both the existence of market-timed securities transactions based on the allegedly wrongful pricing and that these transactions injured them.

Allegations that securities are wrongfully valued concern conduct that is inherently "in connection with" the purchase or sale of securities, because each day's price exists solely to determine how much each investor must pay or will receive for a purchase or sale. Here, in addition, the allegations assert that the defendant's alleged misconduct would not have caused plaintiffs' alleged injuries absent the purchases and sales by the market timers. Thus, the alleged misconduct in market timing class actions is "in connection

with" securities transactions so as to fall within SLUSA's preemptive reach.

C. "In Connection With" Plaintiffs' Own Purchases, Either Before or During the Class Period.

In addition, as is the case for many state law actions filed on behalf of a class of "holders," the market-timing class actions explicitly or implicitly involve allegations under Section 10(b) and Rule 10b-5, based on plaintiffs' and class members' own securities purchases. In the past two years, hundreds of cases have been brought, complaining of market-timing in mutual funds and variable annuity subaccounts. Most of these have been brought in federal court asserting federal causes of action.

Implicit in any "holder" allegations about market--timing is the complaint that the plaintiffs were misled or manipulated into purchasing the securities. If the plaintiffs had purchased the securities expecting other investors to make market-timed transactions, they would have no basis for complaint. On the other hand, if the securities were represented as arbitrage-proof or if purchasers were assured that market-timed trades would be prevented, Section 10(b) or Rule 10b-5 potentially provides investors claiming to have been harmed by market-timed trades with a means of redress. *See Kircher,* 403 F.3d at 484 ("plaintiffs' claims depend on statements made or omitted in connection with *their own* purchases of the funds' securities").

Indeed, in the original complaint filed against Pacific Life, the plaintiff alleged that the defendant had convinced the plaintiff and other investors to purchase variable annuity contracts by marketing the advantages of long-term ownership of variable annuities over direct investment without providing complete and truthful information to plaintiff and the class about its pricing and the risks of dilution of long-term contract holders' investments as a result of arbitrage facilitated by that pricing. However, in

his current complaint – an effort at SLUSA-proofing the allegations – plaintiff has carefully worded the complaint to focus almost uniformly on conduct that affected him after he purchased the security and has expressly excluded claims based on Pacific Life's conduct in connection with his or class members' purchases or sales of securities.[5] The alleged events out of which these claims arise, and the relief requested, are identical.

If SLUSA is to have the result Congress intended, it is necessary to consider not only the allegations as carefully drafted by counsel eager to avoid SLUSA, but also whether the events complained of necessarily include conduct subject to Section 10(b) and Rule 10b-5 prohibitions, and therefore could have been addressed in a private or government enforcement action under those provisions. Absent the safeguard of considering the underlying nature of the complaint, any but the most inept or inattentive of plaintiffs' counsel will quickly hone the techniques of drafting complaints to avoid preemption. And SLUSA will be rendered wholly ineffective for preventing federal securities fraud actions involving nationally traded securities from being brought in state courts and subjected to varying state laws. Because this "is the very sort of maneuver that SLUSA was designed to prevent," *Kircher*, 403 F.3d at 484, courts must look behind the words of the complaint to determine whether a plaintiff's grievance is properly addressed as a securities fraud claim. *Accord Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 300 (3d Cir. 2005); *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 879-80 (8th Cir. 2002).

With respect to market timing in variable annuity subaccounts and mutual funds, the inherent nature of the claims is rendered particularly apparent by the SEC's

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[5] Plaintiff voluntarily dismissed his first complaint and filed a redrafted complaint soon thereafter.

decisions to bring such claims under Section 10(b) and Rule 10b-5, and to successfully settle them.[6]

Such actions meet the "in connection with" requirement of Section 10(b) and Rule 10b-5 because the defendants' alleged misconduct is "in connection with" the purchases of investors who were misled. That connection provides a second basis for finding that private class actions arising out of market-timed trades meet SLUSA's "in connection with" requirement.

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[6] *See, e.g., In re CIHC, Inc.*, No. 3-11578, Securities Act Release No. 8455, Exchange Act Release No. 50165, Investment Co. Act Release No. 26526 (Aug. 9, 2004) (SEC found, in connection with settlement, that defendants, including issuer of variable annuity products, violated Section 10(b) and Rule 10b-5 by misrepresenting that action would be taken to limit market timing and then facilitating market-timed transactions); *In re Inviva, Inc.*, No. 3-11579, Securities Act Release No. 8456, Exchange Act Release No. 50166, Investment Co. Act Release No. 26527 (Aug. 9, 2004) (same).

CONCLUSION

For the foregoing reasons, the Court should rule that the *Blue Chip Stamps* purchaser-seller limitation was not incorporated into SLUSA, and does not confine SLUSA's preemptive scope. Thus, many "holder" allegations allege misconduct "in connection with" securities transactions and therefore within SLUSA's preemptive reach.

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IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Petitioner,

v.

SHADI DABIT, on behalf of himself and all others similarly situated,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF *AMICI CURIAE* OF THE SECURITIES INDUSTRY ASSOCIATION AND THE BOND MARKET ASSOCIATION IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the preemption provision of the Securities Litigation Uniform Standards Act, which bars class actions based upon state law that allege "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security," applies to securities class actions by persons who allege they held securities in reliance upon a misrepresentation or omission about a covered security.

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INTEREST OF THE *AMICI CURIAE*[1]

The Securities Industry Association ("SIA") brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at www.sia.com.)

The Bond Market Association ("TBMA") represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. TBMA's members transact business in a wide variety of public and private fixed-income securities. Its membership comprises a diverse mix of securities firms and banks, including large, multi-product firms and companies with special market niches. It includes all primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in federal agency securities, mortgage-backed and asset-backed securities, corporate bonds, money market instruments, and funding instruments such as repurchase and

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[1] Pursuant to this Court's Rule 37.6, *amici* SIA and TBMA state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici* and their members made a monetary contribution to the preparation or submission of the brief. Counsel of record for both parties have consented to the filing of this brief, and the letters of consent have been filed with the Clerk.

securities lending agreements. From its inception in 1976, TBMA has worked with its member firms, Congress, the SEC, the Federal Reserve Board and the Federal Reserve Bank of New York, state regulators, and self-regulatory organizations to foster effective, efficient regulation; to enhance the liquidity and efficiency of the fixed income markets; to encourage sound credit and business practices for participants in such markets; and to promote the highest levels of professional standards and conduct in such markets. TBMA's efforts to encourage efficient regulation of U.S. markets serves to encourage foreign as well as domestic securities issuance in the United States. In 2004, there were $46.4 billion in dollar-denominated debt securities issued in the United States by foreign companies, most through TBMA members.[2] (More information about TBMA is available at www. bondmarkets.com.)

The SIA and/or TBMA have previously filed *amici* briefs with the Court in cases affecting civil liability and the federal securities laws. See, *e.g.*, *Dura Pharms., Inc.* v. *Broudo*, 125 S. Ct. 1627 (2005); *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002); *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350 (1991); *Rodriguez De Quijas* v. *Shearson/Amer. Express, Inc.*, 490 U.S. 477 (1989); *Shearson/Amer. Express, Inc.* v. *McMahon*, 482 U.S. 220 (1987).

The issue raised by this case is whether holders of securities who refrained from selling, i.e., those who held onto securities, in reliance upon an alleged misrepresentation can bring state-law class actions that survive the preemption provision of the Securities Litigation Uniform Standards Act ("SLUSA"). This issue is one of great import to the securities industry and investors in this era of proliferating securities litigation. It is critically important to the SIA and TBMA that

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[2] This figure does not include foreign issues with maturities of one year or less, certificates of deposit, or convertible bonds.

the effort of Congress to curb vexatious litigation in state law securities class actions by enacting the uniform national requirements of SLUSA, not fall prey to plaintiffs who attempt creatively to plead around SLUSA preemption and the stricter federal securities standards. Such uniform standards are critical to the use of U.S. securities markets by both domestic and foreign issuers. *Amici* therefore have a vital interest in the issue presented in this case, and their views and experience can assist the Court in resolving that issue.

STATUTORY PROVISIONS INVOLVED

Securities Litigation Uniform Standards Act:

> No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging – (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1).

Securities and Exchange Act § 10(b):

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as

necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

INTRODUCTION AND SUMMARY OF ARGUMENT

This case presents the question whether the SLUSA preemption provision applies to state law class action claims brought by holders of securities. An illustration will demonstrate the vastly different outcomes under the conflicting approaches. Suppose H buys stock at a price of $40 per share in defendant D *before* any alleged fraud. As time passes, the stock price climbs to $50. D allegedly suffers a business setback that it conceals for a period of time. *After* the alleged concealment begins, P purchases D's stock at $50 per share. Later, when the setback is subsequently disclosed, D's stock price drops to $30. H has remained a holder of D's stock throughout.

P brings a federal § 10(b) class action alleging that the concealment caused those who purchased after the concealment began to suffer a loss from the post-purchase decline caused by the disclosure of the setbacks. Of course, the purchaser class action may proceed.

Separately, H brings a class action based on state law alleging that the concealment caused the holder class to refrain from selling at the $50 price.[3] This case concerns whether the holder class action may proceed in state court. The position of respondents and the plaintiff class action bar is that the holder case proceeds. Under their approach, the holder's state law class action would probably sue for both fraud and negligence, and for both compensatory and punitive damages, "in the hope that a local judge or jury may produce

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[3] As we demonstrate *infra* at 17-18, the premise that a class of holders could have sold at the $50 price if the truth were disclosed earlier is economic nonsense.

an idiosyncratic award." *Kircher* v. *Putnam Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005) (Easterbrook, J.), *rehearing denied*, 2005 U.S. App. LEXIS 7914 (7th Cir. May 2, 2005), *petition for cert. filed*, No. 05-409 (U.S. Sept. 29, 2005).

The text of SLUSA, its legislative purpose, and the judicial interpretation of similar language in Section 10(b) of the Securities Exchange Act of 1934 all support the conclusion that the natural meaning of SLUSA preempts state law class action holder claims. In particular, SLUSA expressly preempts *every* state law class action claim "by any private party" that is predicated upon a misstatement "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). As this Court held in *United States* v. *O'Hagan*, 521 U.S. 642 (1997), the same language in § 10(b) requires "deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller." *Id.* at 658.

Holder class actions are necessarily dependent on two connections between an alleged deception and the purchase or sale of a covered security. First, holder class claims necessarily assert that a deception artificially inflated the prices at which a covered security held by the class was traded in the stock market. Second, holder class claims necessarily assert that a subsequent corrective disclosure of a prior deception deflated the price at which the security was traded in the stock market. These two connections between the alleged deception and stock market purchases and sales are more than sufficient to cause holder class actions to fall within SLUSA's express preemption provision.

A narrower reading of the "in connection with" language in SLUSA is not supported by *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), which created a judicial rule that a civil plaintiff pursuing the judicially-implied § 10(b) private right of action must be a purchaser or seller. This is because, as this Court held in *O'Hagan*, a year *before* SLUSA was enacted, *Blue Chip Stamps* was not based on an interpretation

of § 10(b)'s language: "We so confined the § 10(b) private right of action because of 'policy considerations.'" 521 U.S. at 664.

According the SLUSA language its broad natural meaning so that it applies to holder class actions is also essential to accomplishing SLUSA's purpose of achieving national uniformity in securities litigation. Otherwise, every securities fraud case will spawn two competing class actions: (1) A federal court class action on behalf of allegedly defrauded purchasers; and (2) a state court class action on behalf of allegedly defrauded holders.[4] Inevitably, many cases would become engulfed in conflicting substantive rulings and procedural requirements. Over time, permitting holder class action suits to proceed in state court would create an increasingly disorienting labyrinth of differing state and federal securities standards. This lack of uniformity concerning the U.S. securities markets would deter potential domestic and foreign issuers from issuing securities in U.S. markets rather than incurring the costs of being subject to both federal standards *and* 50 state standards that are always in a state of flux.

Moreover, absent preemption, the myriad statutory and common law actions available under state law inexplicably could provide a class of holder plaintiffs with a host of substantive and procedural advantages over a purchaser class's § 10(b) claim. For example, scienter is required for a purchaser to bring a §10(b) claim, but sometimes state statutory or common law claims do not require scienter. Congress views purchasers as the principal victims of securities fraud. Congress has undeniably limited purchaser

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[4] To complicate matters further, many investors would be members of both the purchaser and holder class. Any person who purchased both before and after the fraud would be a member of the holder class (for purchases before the fraud) *and* the purchaser class (for purchases after the fraud).

class actions to federal remedies, and completely preempted any state law claim on behalf of a class of purchasers. It defies logic that Congress would destroy the national uniformity sought by SLUSA in order to permit a full panoply of state law remedies to a class of holders of securities.

Such disparate treatment would be particularly inexplicable because prior to SLUSA, federal courts had established that preexisting holders of securities cannot be injured as a class by a subsequent misrepresentation. In such a circumstance, if a truthful disclosure had been made to the holder class, instead of the material misrepresentation, the stock price for the class of existing holders would immediately *decline* before preexisting holders could sell at a higher price. Or, as Judge Henry Friendly succinctly observed 34 years ago: "if the [mis]representation had not been made, the price of the stocks would not have been inflated, and there would have been no gain to be realized by a sale" by the class of holders. *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 329, 333-34 (2d Cir. 1971). It therefore would be bizarre for Congress to have destroyed national uniformity by excepting holder class actions from SLUSA preemption. This Court should read SLUSA preemption consistent with its text, Congressional intent, and sound policy, and apply SLUSA to preempt state class action holder claims, just as SLUSA preempts state class action purchaser and seller claims.

ARGUMENT

I. THE NATURAL MEANING AND POLICY OF THE SLUSA PREEMPTION PROVISION REQUIRES PREEMPTION OF HOLDER CLASS ACTIONS.

A. The Text Of SLUSA Supports Preemption.

The extent of a statute's preemptive effect should be determined by the "natural meaning" of its language. *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 383-84

(1992). SLUSA preemption applies whenever "any private party" brings a class action claim that relies on a misrepresentation or omission "in connection with the purchase or sale of *a* covered security." 15 U.S.C. § 78bb(f)(1) (emphasis added).[5] Respondents improperly seek to add a requirement that the affected purchase or sale have been made "by the class members." These quoted words, however, do not appear in the SLUSA preemption provision.

Holder class actions rely on at least two connections between a misstatement and "the purchase or sale of a covered security," *id.*, regardless of whether the class members themselves purchased or sold the security in reliance upon the alleged misstatement. First, as this case illustrates, holder class actions necessarily are predicated upon a misstatement "in connection with the purchase or sale of a covered security" because they allege that a misstatement inflated the company's publicly-traded share price above its true value. See Pet. App. 6a (discussing respondents' "allegations concerning Merrill Lynch's causing certain stocks to trade at 'artificially inflated' prices through the use of deceptive devices alleged to be the 'hallmarks of stock manipulation'"); see also J.A. 53a (Am. Compl. ¶ 4) ("Throughout the Class Period the price of the ML Stocks promoted by ML were artificially inflated as a result of the manipulative efforts of ML. As a result of the efforts of ML and its agents, employees and affiliates, ML was able to, and did, manipulate the price of the ML Stocks, causing these stocks to trade at artificially inflated prices."); *accord id.* at 54a-56a, 59a-60a, 62a (Am. Compl. ¶¶ 10-16, 26, 34); *Dura*, 125 S. Ct. at 1634 (describing this type of allegation as "purchase price inflation"). Such alleged market price inflation requires that numerous purchases of securities be

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[5] SLUSA preemption does not apply to individual (*i.e.*, non-class) claims, *see* 15 U.S.C. § 78bb(f)(3)(A)(i), or to stocks that are not traded nationally. *See id.* § 78bb(f)(5)(E); *id.* § 77r(b).

made in reliance upon the alleged material misstatement. Specifically, such alleged inflation occurs only when "the *market* price of shares *traded* on well-developed markets reflects all publicly available information and, hence, any material misrepresentations." *Basic, Inc.* v. *Levinson*, 485 U.S. 224, 246 (1988) (emphases added).

Second, holder class actions necessarily rely upon an additional "connection" between a misrepresentation or omission and "the purchase or sale of a covered security." Specifically, a holder class action cannot even theoretically allege or prove injury unless disclosure of the misstatement caused a decline in the price of the stock held by the class members. Such an alleged decline exists only if a "lower price . . . reflect[s]" that actual purchases and sales were made in reaction to the corrective disclosure of "the earlier misrepresentation." *Dura*, 125 S. Ct. at 1631-32. See, *e.g.*, J.A. 53a (Am. Compl. ¶ 5: alleging "subsequent decline in the ML Stocks' values once the investigations become known"); *id.* at 53a-54a (Am. Compl. ¶ 7). Because state law holder class actions are predicated on two "connection[s] with the purchase or sale of a covered security," SLUSA expressly preempts them.

Moreover, when Congress has wanted to limit a statutory reference to civil actions brought only by securities purchasers or sellers, it has done so expressly. Thus, numerous express causes of action in the 1933 and 1934 Acts are expressly limited to civil actions brought by purchasers or sellers. See, *e.g.*, 15 U.S.C. § 77l(a) ("the person purchasing such security"); *id.* § 78r(a) ("any person . . . who . . . shall have purchased or sold"); *id.* § 78t-1(a) ("any person who . . . has purchased . . . or sold"); see also *id.* § 77k(a) ("any person acquiring"). In stark contrast, SLUSA applies to a class action claim brought by "any private party" that relies on a misstatement "in connection with the purchase or sale of a covered security." *Id.* § 78bb(f)(1). If Congress had wanted to exclude holder class actions from SLUSA preemption,

Congress would have used a term such as "any person who has purchased or sold," rather than "any private party."

B. This Court's Interpretation Of Section 10(b) In *O'Hagan* Cannot Be Squared With A Non-Preemptive Reading Of SLUSA.

United States v. *O'Hagan*, 521 U.S. 642 (1997), holds that in "indictments for violations of § 10(b) and Rule 10b-5," there is no requirement that a purchaser or seller have relied on a material misstatement or omission. *Id.* at 664-65 (citing *United States* v. *Naftalin*, 441 U.S. 768, 774 n.6 (1979)); *Holmes* v. *Securities Investor Prot. Corp.*, 503 U.S. 258, 280 (1992) (O'Connor, J., joined by White and Stevens, JJ., concurring in part and concurring in judgment) ("[T]he purchaser/seller standing requirement for private civil actions under § 10(b) and Rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions."). In particular, *O'Hagan* explained that "[t]he misappropriation theory comports with § 10(b)'s language, which requires deception 'in connection with the purchase or sale of any security,' *not* deception of an identifiable purchaser or seller." 521 U.S. at 658 (emphasis added). This means that § 10(b) can be violated "even though the person or entity defrauded is not the other party to the trade." *Id.* at 656. As described *supra*, at 8-9, a holder class action depends on two connections between the alleged deception and stock market purchases and sales, even if the holders are not parties to those trades.

Nor is there any basis to argue that *O'Hagan*'s interpretation of the "in connection with" language applied only to criminal cases, such that the exact same language somehow may have a narrower meaning in civil cases. To the contrary, because *O'Hagan* was a criminal case, the rule of lenity applied. Under the rule of lenity, *O'Hagan* could have reached its interpretation of § 10(b) only if Congress "ha[d] spoken in clear and definite *language*." *Scheidler* v. *National Org. for Women, Inc.*, 537 U.S. 393, 409 (2003) (emphasis

added). Thus, *O'Hagan* inherently ruled that in § 10(b)'s "in connection with" requirement, Congress had spoken in "clear and definite language" that proof of deception of an identifiable purchaser or seller was *not* required.[6]

Because SLUSA was enacted a year *after O'Hagan*, there is no room for respondents to argue that the similar "in connection with" language in SLUSA can be read to require that the alleged victims have been purchasers or sellers. Moreover, were this Court to adopt respondents' position, it would inevitably suggest that *O'Hagan* had misconstrued the "in connection with language," thus calling into question the elements necessary for a federal securities fraud criminal prosecution or an SEC enforcement action.

C. *Blue Chip Stamps* Was Not Based On An Interpretation Of The "In Connection With" Language.

The Second Circuit properly did not and could not say that the language of SLUSA's preemption provision itself fell short of covering a holder class action. Rather, its decision rests entirely on the premise that when SLUSA was enacted in 1998, *Blue Chip Stamps* was the existing, authoritative interpretation of similar language appearing in § 10(b). Pet. App. 27a, 29a. But, this premise is flawed because *O'Hagan* held in 1997, *before* SLUSA's enactment, that *Blue Chip*

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[6] Indeed, a dissent, as well as respondent O'Hagan and his *amici*, argued that the "principle of lenity" supported the opposite interpretation of § 10(b). *O'Hagan*, 521 U.S. at 679 (Scalia, J., concurring in part and dissenting part); *see* Brief of Respondent-Appellee, *United States* v. *O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), *available at* 1997 WL 143801, at *11, *29, *33; Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent, *United States* v. *O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) *available at* 1997 WL 143793, at *23-*24 & n.21; Brief of National Association of Criminal Defense Lawyers as *Amicus Curiae* in Support of Respondent, *United States* v. *O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), *available at* 1997 WL 145007, at *6.

Stamps did not rest on interpreting the "in connection with" language of § 10(b).

Specifically, in *O'Hagan*, the Court, quoting *Blue Chip Stamps*, 421 U.S. at 737, held: "We so confined the §10(b) private right of action because of 'policy considerations.'" *O'Hagan*, 521 U.S. at 664. When Congress in 1998 borrowed the existing judicial interpretation of the "in connection with" language in § 10(b) when it enacted SLUSA, Congress surely borrowed *O'Hagan*, this Court's then-most recent decision. See also *Holmes*, 503 U.S. at 284 (O'Connor, J., joined by White and Stevens, JJ., concurring in part and concurring in the judgment) ("The purchaser/seller standing limitation in Rule 10b-5 damages actions thus does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.'"); *id.* at 289-90 (Scalia, J., concurring in the judgment) ("[T]he limitation we approved in *Blue Chip Stamps* was essentially a legislative judgment rather than an interpretive one."). *O'Hagan* authoritatively held that *Blue Chip Stamps* was *not* a construction of § 10(b)'s language. 521 U.S. at 664-65.

O'Hagan was right. *Blue Chip Stamps* itself demonstrates that it addressed not the meaning of § 10(b)'s words, but rather the policy question of how to confine the judicially-created implied right of action for § 10(b) violations. The majority stated, "we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 737. The Court concluded,

> we are not dealing here with any private right created by the express language of §10(b) or Rule 10b-5. *No language* in either of those provisions *speaks at all* to the contours of a private cause of action for their violation. . . . We are dealing with a private cause of action which has been judicially found to exist, and which will have to be *judicially delimited* one way or

> another unless and *until Congress addresses the question.*

Id. at 748-49 (emphases added). Because, as *O'Hagan* holds, *Blue Chip Stamps* was not based on interpreting the "in connection with" language, it provides no basis on which to constrict that language in SLUSA to less than its natural meaning.

D. SLUSA's Policy Of Achieving Uniformity In The Standards Governing U.S. Securities Litigation Supports Preemption.

As is evident from the very title of SLUSA, its purpose was to ensure "Uniform Standards" for "Securities Litigation." Thus, the Senate Report stated:

> Proponents of the legislation have argued that we live in an information age in which we have truly national, if not international, securities markets and that uniform standards are entirely consistent with Congress's preeminent power over the regulation of interstate and foreign commerce. The Committee ... found the interest in promoting efficient national markets to be the more convincing and compelling consideration in this context.

S. Rep. No. 105-182, at 4 (1998). In particular, the Senate Report stated that allowing state class action securities litigation would deter efforts to raise capital. *Id.* at 5.

In determining the scope of a statute's preemptive effect, the Court should ensure that Congress's policy choices are implemented. See, *e.g.*, *Metropolitan Life Ins. Co.* v. *Massachusetts*, 471 U.S. 724, 746-47 (1985). Respondents' position that SLUSA permits state law holder class actions would undermine the uniform federal standards for U.S. securities class action litigation that Congress sought to achieve. As noted above, respondents' position would create both procedural morasses in specific cases, and also differing

standards governing U.S. securities litigation between the federal and state systems and among the various states. See *supra* at 6.[7]

As this Court recognized in *Blue Chip Stamps*, faced with potential securities class actions from all securities holders – not just purchasers and sellers – potential securities issuers and securities firms may conclude that "'[t]he hazards of a business conducted on these terms are [too] extreme.'" 421 U.S. at 748 (quoting *Ultramares Corp.* v. *Touche*, 174 N.E. 441, 444 (N.Y. 1931) (Cardozo, C.J.)). Indeed, this Court has recently reaffirmed that it is bad policy to permit the "'*in terrorem*'" effect produced by meritless but large class actions. *Dura*, 125 S. Ct. at 1634 (quoting *Blue Chip Stamps*, 421 U.S. at 741).

In particular, SLUSA's legislative history indicates that as foreign securities markets grow, this makes it increasingly important to ensure uniformity and certainty in the U.S. securities markets. 143 Cong. Rec. S10475, S10477 (daily ed. Oct. 7, 1997), *available at* 1997 WL 614735 ("[I]f our markets are to remain ahead of those in London, Frankfurt, Tokyo or Hong Kong, we must create uniformity and certainty."). If SLUSA is not read to preempt state holder class actions, at least some foreign companies would be deterred from issuing securities in the United States by the morass of having to litigate both state and federal class action

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[7] After SLUSA, Congress enacted the Class Action Fairness Act ("CAFA") in February 2005. CAFA's removal provision does not authorize removal of "a claim concerning a covered security." 28 U.S.C. § 1453(d)(1). The legislative history explains that "for a precipitous drop in the value of . . . stock, based on fraud" claims were already made removable and preempted by SLUSA. S. Rep. No. 109-14, at 49-50 (2005). Of course, holder class claims are claims "for a precipitous drop in the value of . . . stock." *Id.* Assuming, for the sake of argument, however, that SLUSA is not read to preempt state law holder class actions, most state law holder class actions would spring up in state courts and could not be removed.

suits under differing and inevitably changing standards. *See id.* ("How can we expect to get foreign companies to list on our exchanges if we have to explain that they will face not only our very tough Federal standards on securities fraud, but also the possibility of 50 constantly changing State standards").

II. NO POLICY RATIONALE SUPPORTS READING SLUSA NOT TO PREEMPT HOLDER CLASS ACTION STATE LAW CLAIMS.

A. The Non-Preemptive Reading Of SLUSA Would Illogically Create Greater Potential Remedies For Holders Of Securities Than For Purchasers And Sellers.

Given SLUSA's policy of ensuring uniform standards in securities litigation, the burden falls on respondents to identify some policy rationale in SLUSA that would logically support treating the preemption of holder class actions differently from purchaser class actions. There is no such rationale.

If SLUSA is not read to preempt holder class action claims, holder class members could illogically be given a better status than purchaser class members. This is because holder class members would argue that state law gives them more robust remedies and litigation tools than those available to federal class action plaintiffs who actually purchased or sold securities in reliance upon a misrepresentation or omission.

SLUSA prevents purchasers and sellers of a security from bringing class action claims based on state law even if they are pendent to their federal claims. See 15 U.S.C. § 78bb(f)(1) (preempting state law class actions claims "in any State or Federal court"); *Rieger* v. *Drabinsky* (*In re Livent, Inc. Noteholders Secs. Litig.*), 151 F. Supp. 2d 371, 385, 442-43 (S.D.N.Y. 2001) (dismissing pendent state claims for common law fraud, negligence and negligent misrepresentation by purchasers). Purchasers bringing

§ 10(b) class actions in federal court must allege and prove, *inter alia*, scienter. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 (1976). They must satisfy heightened pleading standards, see Fed. R. Civ. P. 9(b), *Ganino* v. *Citizens Utils. Co.*, 228 F.3d 154, 168 (2d Cir. 2000), and comply with an initial stay of discovery, see 15 U.S.C. § 78u-4(b)(3). If purchasers prevail, their remedies exclude punitive damages. See *id.* § 78bb(a) (judgment in excess of actual damages is impermissible under the 1934 Act); see, *e.g.*, *Pelletier* v. *Stuart-James Co.*, 863 F.2d 1550, 1557 (11th Cir. 1989) ("'Actual damages' has been interpreted to mean some form of economic loss and does not include punitive damages.").

If holders are permitted to bring state law class actions, they would argue that state law gives them a better litigation arsenal than § 10(b) purchaser plaintiffs have. States would potentially allow punitive damages,[8] the exaction of burdensome, costly discovery prior to the motion to dismiss stage, and minimal notice pleading. Holder class plaintiffs often would claim multiple state-law theories of recovery including fraud, negligent misrepresentation, and statutory remedies such as unfair and deceptive trade practices (often with treble damages). Some state claims would also be accorded a lengthier statute of limitations period.[9]

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[8] *See, e.g. Voskamp* v. *Arnoldy*, 749 S.W.2d 113, 120-21 (Tex. App. 1987) (affirming award of $3,750,000 in punitive damages when actual damages from securities fraud totaled $1,001,850).

[9] Under Sarbanes-Oxley, a § 10(b) claim must be brought no later than the earlier of two years from discovery or five years after the violation. 28 U.S.C. § 1658(b). Some state statutes of limitations appear to be longer than two years from discovery or five years from the violation. *See, e.g.*, Ind. Code Ann. § 23-2-1-19(g) (three years from discovery but not more than six years from sale); S.C. Code Ann. § 35-1-1530 (in some instances, three years from discovery or when discovery should have occurred); N.H. Rev. Stat. Ann. § 421-B:25(VII) (six years from payment to a broker-dealer or issuer); Wash. Rev. Code § 21.20.430(4)(b) (in some cases, three years from discovery).

It is incomprehensible that Congress (or anyone) would have created a system where class actions for securities holders even arguably would have more robust potential remedies and litigation tools than class actions for purchasers and sellers. Accordingly, no policy rationale supports undermining SLUSA's purpose of achieving uniform standards in securities litigation by permitting state law holder class action claims.

B. A Class Of Holders Of Securities Cannot Be Injured By A Misrepresentation.

It would be passing strange to attribute to Congress an intent to allow potentially greater remedies for holder class claims than for purchaser class claims because, prior to SLUSA, every federal court to examine a holder class claim had concluded that, as a class, holders cannot be injured by a misrepresentation or omission.[10] This was best explained in *Crocker* v. *FDIC*, 826 F. 2d. 347 (5th Cir. 1987):

> The flaw in the [holders'] argument is that it assumes a market for the stock existed at an artificially high price. This inflated price, and hence the particular market for the stock, was maintained only because of the wrongdoing of the [defendants], who concealed material financial information from the shareholders and the public that would have demonstrated the failing condition of the [company]. It follows that, had this information been released, the stock price would have immediately and precipitously fallen especially if, as is implicit in the [holders'] theory, an entire class of shareholders had simultaneously dumped their stock on the market. Thus, there would have been no market for the stock at the artificially high price. Without such a market, the [holders'] envisioned "profit opportunity" evaporates into hardly more than an illusion.

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[10] Prior to SLUSA, in federal courts, such holder class claims were usually brought in either RICO or diversity cases.

Id. at 351 (footnote omitted).

Applying *Crocker*'s analysis to our earlier hypothetical illustration, *supra*, at 4, it is clear what would have happened to the holder class if there had been no post-purchase misrepresentation concerning the business setback. Under that hypothetical, if the business setback had been promptly disclosed to the class of existing holders, D's stock price would have fallen from $50 to $30 almost instantaneously. See *Basic*, 485 U.S. at 246 n.24 The holder class simply could not have responded to disclosure of the truth by selling at the pre-disclosure artificially inflated price.

A misrepresentation merely postpones the timing of the preexisting holders' recognition of a loss from a business setback, but the misrepresentation itself does not cause any loss. For the preexisting holder class, the earlier business setback (not its concealment) causes any loss. *Accord Kagan* v. *Edison Bros. Stores, Inc.*, 907 F.2d 690, 691-92 (7th Cir. 1990); *Arent* v. *Distribution Scis., Inc.*, 975 F.2d 1370, 1374 (8th Cir. 1992) ("[A]ny injury to plaintiffs was not caused by [defendant's] failure to disclose. Plaintiffs were not harmed because they were unable to realize the true value of their stock – they were harmed because the true value of their stock was zero."); *Chanoff* v. *United States Surgical Corp.*, 857 F. Supp. 1011, 1018 (D. Conn. 1994), *aff'd*, 31 F.3d 66 (2d Cir. 1994) (per curiam); see also *Levine*, 439 F.2d at 329, 333-34 (Friendly, J.) (holding that even if the purchaser-seller requirement was overruled, a holder class could not prove injury, because "if the representation had not been made, the price of the stock would not have been inflated, and there would have been no gain to be realized by a sale").

The Congress that enacted SLUSA surely did not intend to permit state law securities class actions that essentially seek "a partial downside insurance policy" against business setbacks. *Dura*, 125 S. Ct. at 1634. That is exactly what holder class actions do. Rather, SLUSA's purpose of encouraging capital formation in U.S. markets by mandating

uniform federal standards for securities class actions can be achieved only if holder state law class actions are preempted.

III. SLUSA'S LEGISLATIVE HISTORY DOES NOT SUPPORT AN EXCEPTION FOR HOLDER CLASS ACTION STATE LAW CLAIMS.

Assuming, *arguendo*, that there is any reason to resort to legislative history in this case, nothing in SLUSA's legislative history refers to holder class actions. The Second Circuit nonetheless relied upon floor comments of Senator Dodd that "[t]his legislation has been carefully crafted only to affect those types of class actions that are appropriately heard on the federal level." 143 Cong. Rec. S10475, S10477 (daily ed. Oct. 7, 1997), *available at* 1997 WL 614735. Senator Dodd's statement followed a list of claims that the bill expressly did not affect. The list included "individual actions in State court . . . penny stocks, delisted securities, roll-ups . . . securities sold only within a single State . . . bad brokers . . . investment advisors . . . [and] State regulators." *Id.* State holder class actions were not included in the list and were not addressed by the Senator.

In context, Senator Dodd's comments provide no basis to find an exception in SLUSA's preemption provision for holder class actions. Senator Dodd was not even purporting to address the meaning of SLUSA's "in connection with" language. If Senator Dodd's comments are twisted to mean that preemption applies only if the claims of the class are "appropriately heard on the federal level," this would permit state law class claims *for purchasers* that could not satisfy the elements of a § 10(b) claim. For example, if a class of purchasers could not satisfy the § 10(b) requirements of scienter, loss causation, timeliness, or the like, they would argue that SLUSA did not preempt their state law claims for negligence and the like because those claims are not

"appropriately heard on the federal level."[11] Senator Dodd could not have meant this. The ambiguous comments of a single Senator that have no basis in the actual statutory language provide no ground to constrict SLUSA's natural meaning. See, *e.g.*, *Morales*, 504 U.S. at 383-85 & n.2 (holding that "natural meaning" of preemption provision of "'any . . . regulation . . . relating to rates, routes, or services'" reached state regulation of advertising even though the "legislative history contains no statements specifically addressed to state regulation of advertising").

Only by according SLUSA's preemption provision its broad natural meaning can this Court avoid destroying SLUSA's goals of achieving national uniformity and preventing vexatious securities lawsuits. SLUSA's "pre-emptive effect is not confined to knocking out state-law claims by investors who have *winning* federal claims, as plaintiffs suppose. It covers both good and bad securities claims – *especially* bad ones." *Kircher*, 403 F.3d at 484 (emphases in original). Thus, SLUSA preempts state law holder class actions.[12]

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[11] These concerns are not fanciful. As the SEC noted in its *amicus* brief in the Second Circuit supporting preemption, Pet. App. 96a & n.5, some lower courts have already used similar reasoning to hold that SLUSA permits *purchaser* state law class actions for negligence. *See Green* v. *Ameritrade, Inc.*, 120 F. Supp. 2d 795, 798-99 (D. Neb. 2000) (holding, in part, that a state law "claim [was] not preempted by SLUSA because no proof of scienter [was] required" by the state law claim), *aff'd on other grounds*, 279 F.3d 590 (8th Cir. 2002); *Burns* v. *Prudential Secs.*, 116 F. Supp. 2d 917, 924-26 (N.D. Ohio 2000) ("[P]laintiffs' allegations do not satisfy the scienter requirement for securities fraud under § 10(b) and Rule 10b-5. Because § 10(b) and Rule 10b-5 are nearly identical to the removal criteria set forth at § 78bb(f)(1) of SLUSA, it follows that removal is improper, and remand to state court is the appropriate course.").

[12] If this Court rules that holder class actions are not preempted by SLUSA, such lawsuits would give rise to constitutional questions that are not before this Court in this case. These issues include whether extraterritorial application of a state's securities laws violates the dormant

CONCLUSION

For the foregoing reasons, the judgment of the Second Circuit Court of Appeals should be reversed.

Respectfully submitted,

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commerce clause, *see Edgar* v. *MITE Corp.*, 457 U.S. 624 (1982), and constitutional limitations on essentially punitive remedies that are applied extraterritorially or where the plaintiffs were uninjured, *see State Farm Mut. Auto Ins. Co.* v. *Campbell*, 538 U.S. 408 (2003). This Court should clearly state that it is not reaching any potential federal challenges to state law holders class actions except for SLUSA preemption.

(8)

No. 04-1371

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Petitioner,

v.

SHADI DABIT, on behalf of himself
and all others similarly situated,
Respondent.

**On Writ of Certiorari to the
United States Court of Appeals
For the Second Circuit**

BRIEF OF *AMICUS CURIAE* WASHINGTON LEGAL FOUNDATION IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS CURIAE

The Washington Legal Foundation (WLF) is a nonprofit, nonpartisan public interest law and policy center based in Washington, D.C., with supporters nationwide.[1] WLF engages in litigation and participates in administrative proceedings to defend free enterprise, individual rights, and a balanced civil justice system. To that end, WLF has frequently appeared as *amicus* in this Court and lower courts to address the proper scope of federal preemption. *See, e.g., Buckman Co. v. Plaintiffs' Legal Comm.*, 531 U.S. 341 (2001); *Geier v. American Honda Motor Co.*, 529 U.S. 861 (2000); *Greater N.Y. Metro. Food Council, Inc. v. Giuliani*, 195 F.3d 100 (2d Cir. 1999); *Lindsey v. Tacoma-Pierce County Health Dep't*, 195 F.3d 1065 (9th Cir. 1999); *Taylor v. SmithKline Beecham Corp.*, 658 N.W.2d 127 (Mich. 2003); *Etcheverry v. Tri-Ag Servs., Inc.*, 993 P.2d 366 (Cal. 2000).

WLF frequently publishes policy papers and takes part in litigation and agency proceedings to promote and defend legal rules that protect employees, pensioners, and investors from stock losses caused by abusive securities litigation. Among WLF's recent papers on this topic are James Maloney, *Strict Standing Requirement For Securities Fraud Suits Upheld* (2005); Lyle Roberts & Paul Chalmers, *Lower Courts Will Determine Impact Of Supreme Court's Securities Fraud Suit Ruling* (2005); and Neil M. Gorsuch & Paul B.

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[1] Pursuant to Supreme Court Rule 37.6, *amicus* states that no counsel for any party authored this brief in whole or in part, and that no person or entity, other than *amicus* and its counsel, contributed monetarily to the preparation or submission of this brief. The parties have consented to the filing of all *amicus* briefs; pursuant to Supreme Court Rule 37.3, letters evidencing this consent have been lodged with the Clerk.

Matey, *Settlements In Securities Fraud Class Actions: Improving Investor Protection* (2005).

WLF is concerned that if the decision below is not reversed, the appeals court's interpretation of the Securities Litigation Uniform Standards Act of 1998 would undermine the express preemption provision of that legislation and thereby re-open the door to vexatious securities lawsuits that Congress intended to close.

WLF has no interest, financial or otherwise, in the outcome of this lawsuit.

SUMMARY OF ARGUMENT

This case presents the question whether the Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227, 3229-30 (1998), (codified as amended in part at 15 U.S.C. §§ 77p & 78bb(f)), preempts state law class action claims based upon allegedly fraudulent statements or omissions brought solely on behalf of persons who were induced thereby to hold or retain (and not to purchase or sell) securities.

SLUSA expressly preempts any class action based upon state law concerning a material misrepresentation or omission "in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). As petitioner Merrill Lynch cogently explains, the Second Circuit erred in concluding that this provision allows suits to proceed in state court on behalf of persons who merely hold, rather than purchase or sell, securities. The identical "in connection with" statutory language in Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), has long been understood to authorize the Securities and Exchange Commission (SEC) to enforce Section 10(b)'s antifraud requirements even absent a purchase or sale of securities. To be sure, *private* actions to enforce Section 10(b) and Rule

10b-5, are limited to situations involving an actual purchase or sale of securities. As this Court has explained in *United States v. O'Hagan*, however, private actions are "so confined . . . because of 'policy considerations'" related to the potential for baseless and wasteful private litigation, not because the "in connection with" language of Section 10(b) requires any such limitation. 521 U.S. 642, 664 (1997); *see also Holmes v. Securities Investor Prot. Corp.*, 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and concurring in the judgment) ("[t]he purchaser/seller standing limitation in Rule 10b-5 damages actions . . . does not stem from a construction of the phrase 'in connection with the purchase or sale of any security'"); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). Thus, by preempting state class actions alleging misrepresentation "in connection with the purchase or sale" of securities in SLUSA, Congress must be understood to have preempted "holder" claims as well as purchaser/seller claims. In other words, the preemptive scope of SLUSA is coextensive with the scope of the SEC's enforcement authority under Section 10(b) and Rule 10b-5, not with the more limited scope of permissible private actions to enforce those provisions.

That is also the only reading of SLUSA consistent with sound policy and common sense. As Judge Easterbrook explained, "[i]t would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all." *Kircher v. Putman Funds Trust*, 403 F.3d 478, 484 (7th Cir. 2005), *petition for cert. filed*, __ U.S.L.W. __, (U.S. Sept. 29, 2005) (No. 05-409).

As *amicus* WLF will make clear in this brief, the Second Circuit's counterintuitive reading of SLUSA cannot be justified by an appeal to federalism. Principles of federalism, and limitations on the power of the federal government, are of course the bedrock of our Constitution and of the protection of individual freedom. It is equally clear, however, that the framers intended to grant Congress power to prescribe uniform national rules when necessary to promote the flourishing of interstate commerce in our free enterprise system. This is precisely such a situation. The flow of capital manifested in the trading of securities on national exchanges is inherently interstate (indeed international) in character. Long and bitter experience teaches that the efficient operation of capital markets is placed at great risk if the law of the various States can be freely invoked to impose a multitude of different and potentially conflicting obligations.

The reality is that in SLUSA, as well as in the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995), which Congress passed to discourage frivolous class-action litigation, *see* H.R. Conf. Rep. No. 104-369, at 31-32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31, Congress worked a significant change in the relationship between federal securities law and state law.[2] While the PSLRA sought to discourage so-called strike suits by imposing more stringent pleading requirements and mandatory discovery stays, Congress enacted the SLUSA to "prevent certain State private securities class action lawsuits alleging fraud from being

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[2] Additionally, two years before SLUSA, Congress enacted the National Securities Market Improvement Act of 1996 (NSMA), Pub. L. No. 104-290, 110 Stat. 3416 (1996), which preempted some state securities regulation and divided the responsibility for securities registration and investment adviser registration between the SEC and the States.

used to frustrate the objectives of the [PSLRA]." SLUSA, § 2(5). In SLUSA, Congress thus chose to oust state law, and require that securities actions within the federal statute's coverage be brought in federal court or not at all. In so doing, Congress fundamentally altered the pre-existing relationship between federal and state securities law enforcement.

That exercise of Congressional power was entirely appropriate, and indeed at the core of the concerns that the Constitution directs our national government to address. Congress is the most efficient regulator of national securities markets because it, unlike the states, is able to establish uniform regulations that increase market efficiency and encourage the free flow of capital. That point is true regardless of whether the regulations are related to the registration of securities or the liability standards applicable in class-action suits alleging fraud. As one commentator stated, "[s]ince the problems are national, and in some respects international in scope, an effective national regulator seems more appropriate than piecemeal state regulation." Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 Brook. J. Int'l L. 496, 546 (2003).

ARGUMENT

I. The Market For Securities Traded On The National Exchanges Is Inherently National And International In Character And Its Efficient Operation Is Essential For Raising And Distributing Capital.

As the Senate noted in considering SLUSA, "[w]e live in an information age in which we have truly national, if not international, securities markets." S. Rep. No. 105-182 , at 4 (1998). Congress's recent securities regulation statutes seek to reduce costs and increase efficiency by establishing uniform rules. Banking Committee Chairman Senator

Gramm stressed the trend toward uniform national standards for securities regulation when he introduced SLUSA, stating that "[l]egislatively, we have been moving toward national standards for national securities. The National Securities Markets Improvement Act . . . created national rules for many aspects of our national securities markets. [SLUSA] is an important step continuing in that direction, a step in line with the principles behind the commerce clause of the Constitution." 143 Cong. Rec. S10475 (daily ed. Oct. 7, 1997). The trend toward uniform national regulation of the securities market is also evident in international markets. *See* Karmel, *Reconciling Federal and State Interests*, 28 Brook. J. Int'l L. at 547 (surveying changes in securities regulation in the United States and Europe and concluding "[a]s securities markets have become national and even international and significantly affect the national economic welfare in the U.S. and the EU-wide markets in Europe, there has been a trend toward federalizing securities regulation").

Courts have likewise recognized that the securities market is both national in character and essential for the efficient distribution of capital. As this Court has noted, "[l]arge corporations that are listed on national exchanges, or even regional exchanges, will have shareholders in many States and shares that are traded frequently. The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses." *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 90 (1987). State courts likewise recognize that the national character of the securities market. *See Guice v. Charles Schwab & Co.*, 674 N.E.2d 282, 290 (N.Y. 1996) (holding New York law preempted by federal regulations because it "would inevitably defeat the congressional purpose of enabling the SEC to develop and police [a] 'coherent regulatory structure'

for a national market system."); *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918, 925 (Minn. 1996) ("There is no denying the fact that the securities industry has a national or, if more broadly considered, an international scope.").

SLUSA protects the federal policy of encouraging efficient securities markets by preventing circumvention of the Private Securities Litigation Reform Act of 1995. In 1997, the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs held oversight hearings on the operation of the PSLRA. The committee, after hearing extensive testimony, concluded that there was a measurable shift of securities class-action litigation from federal to state court after the passage of the PSLRA. S. Rep. No. 105-182, at 3. Studies showed that although there was a reduction in the number of securities class actions filed in federal court, that reduction corresponded with a similar increase filed in state courts.[3] *See* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 Stan. L. Rev. 273, 307-18 (1998). The Senate Committee concluded that the trend toward state class-action litigation "created a ripple-effect that has inhibited small, high-growth companies in their efforts to raise capital, and has damaged the overall efficiency of our capital markets." S. Rep. No. 105-182, at 4. The Committee expressed specific concerns that the prospect of class actions in state court discouraged corporations from using the "safe-harbor" provision of the PSLRA, which was

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[3] *See also* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465, 1498 (2004). Choi's study confirmed that frivolous securities class-action suits were common in federal court before the PSLRA. He also concluded that post-PSLRA, the number of frivolous suits filed in federal court decreased and there was thus a shift toward meritorious suits. His study reviews only federal filings.

designed to encourage corporations to share valuable forward-looking information with investors. *Id.*

The Committee also stressed that although state regulators play a complementary role in regulating securities markets, SLUSA was necessary because defendants in state-court class actions were denied the protections promised by the PSLRA. *Id.* at 5. The Committee report noted that there was some concern that preempting state securities class actions violated federalism principles, but concluded that "the interest in promoting efficient national markets . . . [is] the more convincing and compelling consideration in this context." *Id.* at 4. The Senate bill as well as the final version approved by the Conference Committee and enacted by Congress were patterned after the NSMIA in that both acts were intended to create uniform national standards in their respective fields. *See* H.R. Conf. Rep. No. 105-803, at 13 (1998) ("Consistent with the determination that Congress made in the National Securities Markets Improvement Act (NSMIA), [SLUSA] establishes uniform national rules for securities class action litigation involving our national capital markets." (footnote omitted)).

SLUSA thus implements the Senate Banking Committee's conclusions that securities class actions had shifted from federal to state court, that the shift prevented the PSLRA from achieving its important objective of reducing frivolous class-action litigation, and that "it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits." SLUSA, § 2(5), 112 Stat. 3227. *See Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107-08 (2d Cir. 2001) (SLUSA "mak[es] federal court the exclusive venue for class actions alleging fraud in the sale of certain

covered securities and . . . mandat[es] that such class actions be governed exclusively by federal law.").

II. The Need For Uniform National Regulations That Promote Efficiency In The Securities Market And The Free Flow of Capital Is An Important National Interest That Justifies Congress's Preemption Of State Securities Class Actions Alleging Fraud.

A. Although the Primary Purpose of Federalism is to Protect the Role of the States in our Federal System, a Necessary Corollary to that Purpose is Respecting the Essential Role of the National Government to Regulate in Specific Spheres.

The Commerce Clause of the Constitution grants the federal government the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3. By virtue of the Supremacy Clause, regulations promulgated under the Commerce Clause supersede state law. *See* U.S. Const. art. VI, cl. 2. James Madison explained the Commerce Clause's delegation of power by pointing out that uniform national regulation benefited the states: "A very material object of this power was the relief of the States which import and export through other States from the improper contributions levied on them by the latter. Were these at liberty to regulate the trade between State and State, it must be foreseen that ways would be found out to load the articles of import and export, during the passage through their jurisdiction, with duties which would fall on the makers of the latter and the consumers of the former." The Federalist No. 42, at 276 (James Madison) (Isaac Kramnick ed., 1987). Alexander Hamilton justified the delegation on the basis that national regulation created a unified market that made the United States a competitive force in international commerce. The

Federalist No. 11, at 129-32 (Alexander Hamilton) (Isaac Kramnick ed., 1987).

Regulation of national securities markets is at the core of the power allocated to the national government in our federal scheme. *See generally*, Larry Kramer, *Understanding Federalism*, 47 Vand. L. Rev. 1485, 1502 (1994) ("There are, after all, two sides to federalism: not just preserving state authority where appropriate, but also enabling the federal government to act where national action is desirable."). At the same time, the considerations that favor protection of state prerogatives, such as protecting individuals by providing a check on national power and encouraging citizen involvement by localizing government, are not implicated here. *See* Perino, *Fraud and Federalism*, 50 Stan. L. Rev. at 320-21. Other federalism principles, such as allowing the states to function as "laboratories" for innovation, *see New State Ice Co. v. Leibmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting), and allowing state government flexibility in responding to local issues, *see Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970), have less force here because experience has shown that giving States a free hand to craft their own standards for securities class actions generates an unacceptably high risk of the kinds of vexatious strike suits (with their coercive pressure to settle unmeritorious claims) that federal law seeks to minimize as a matter of national policy.[4]

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[4] Furthermore, SLUSA is carefully drawn to protect the interests of States by preserving state law in situations where Congress has determined that these risks are not as severe. It applies only to "covered class actions" involving (1) fifty or more named plaintiffs where common questions of law or fact predominate, (2) class actions brought on behalf of unnamed class members, and (3) consolidated suits alleging common questions of law or fact seeking damages for more than fifty plaintiffs. 15 U.S.C. § 77p(f)(2)(A). SLUSA also excludes (1) class actions alleging violations

B. Regulating the National Securities Market is Not a Purely Local Concern.

Regulatory competition among the States is beneficial only where the regulated individuals have real choice. Corporations with securities traded on national exchanges cannot control where their securities are traded. Unlike the market for corporate governance law where a corporation chooses a state of incorporation and opts into its laws, fraud liability is premised on the location of the transaction. Perino, *Fraud and Federalism*, 50 Stan. L. Rev. at 325; UNIFORM SECURITIES ACT § 801 (1985). The absence of real choice in the market for legal standards in securities regulations undercuts the value of the states experimentation. If the corporations are not able to opt out of inefficient liability regimes, the States lack incentives to structure competitive liability rules and "the virtue of innovation disappears and what remain are fifty petty and stultifying tyrannies, rather than fifty laboratories of experimentation." Charles Fried, *Federalism--Why Should We Care?*, 6 Harv. J.L. & Pub. Pol'y 1, 3 (1982-1983).

The application of state fraud laws to securities traded on national exchanges in the form of class-action lawsuits gives

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of the statutory or common law of the state in which the issuer is incorporated, (2) actions brought by a state on its own behalf, as a member of a class comprised of other states, or on behalf of a state pension plan, and (3) actions brought on contractual agreements between issuers and indenture trustees. 15 U.S.C. § 77p(d)(1)-(3). Congress also reserved the authority of state securities regulators to investigate violations and bring enforcement actions based on state law. 15 U.S.C. § 77p(e). Finally, derivative actions based on state corporate law are not preempted. 15 U.S.C. § 77p(f)(2)(B). *See generally*, A.C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 Wash. U. L.Q. 435, 491-94 (2000) (discussing the exceptions).

that law extra-territorial effect. Allowing extra-territorial application creates the risk of externalities because a state can shift the costs of complying with its law from its own citizens to the citizens of other states. *See* Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. Chi. L. Rev. 1484, 1495-96 (1987) (reviewing Raoul Berger, *The Founders' Design* (1987)). A state may have a tangential interest in applying its fraud statutes to protect resident shareholders of resident corporations, resident shareholders of nonresident corporations, and nonresident shareholders of resident corporations; however, as this Court emphasized in *CTS*, a state "has no interest in protecting nonresident shareholders of nonresident corporations." *CTS Corp.*, 481 U.S. at 93 (emphasis omitted). The lack of alignment between the interests of the state in enforcing its fraud laws on a class-wide basis and the cost of enforcement to the state and its residents enhances the risk of negative externalities.

The Senate Banking Committee report foresaw such a negative externality. To avoid liability in an integrated national economy with multiple jurisdictions, all of which may enforce their fraud statutes on a class-wide basis, corporations must conform their statements and forecasts to the most stringent standard, regardless of whether that standard is beneficial to the corporation's shareholders or national securities markets. Given the costs of litigation, risk-averse corporations might reasonably fail to take full advantage of federal safe-harbor provisions in contravention of federal policy. The Senate report cited that "chilling effect" on the use of the federal safe-harbor provision as one reason to adopt SLUSA. S. Rep. 105-182 at 4.

C. Differing Liability Rules in Class Actions Impose Significant Costs that Impair Efficiency and Increase the Price of Capital in the National Securities Markets.

1. This Court has Emphasized the Important Role of Clear and Consistent Fraud Rules in Achieving Efficient Markets.

This Court repeatedly has rejected attempts to expand civil fraud liability under the federal securities laws in an ill-defined or unclear way. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Court rejected the argument that individuals who neither purchased nor sold a particular security could bring a civil fraud action because it did "not believe that such a shifting and highly fact-oriented disposition of the issue of who may bring a damages claim for violation of Rule 10b-5 is a satisfactory basis for a rule of liability imposed on the conduct of business transactions." *Id.* at 755. The Court subsequently rejected the vague "substantial factor" test to determine liable parties under Section 12 of the Securities Act because that test "introduces an element of uncertainty into an area that demands certainty and predictability" and would result in "decisions . . . made on an ad hoc basis, offering little predictive value to participants in securities transactions." *Pinter v. Dahl*, 486 U.S. 622, 652 (1988); *see also Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188-89 (1994) (rejecting aiding and abetting liability under Rule 10b-5 because of the inherent uncertainty such liability entails for secondary parties).[5]

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[5] Recent scholarship vindicates the Court's emphasis. *See* Rafael LaPorta, Florencio Lopez-de-Silanes, and Andrei Schliefer, *What Works in Securities Laws*, __ J. Fin. __ (forthcoming Feb. 2006), available at http://www.afajof.org/jofihome.shtml (follow "Forthcoming Articles"

2. *The Substantial Costs of Frivolous Class Action Litigation Impede the Efficiency of National Securities Markets.*

Class-action litigation, regardless of its merits, always imposes substantial costs. *See generally* Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 Duke L.J. 945 (1993). The costs of frivolous class-action litigation are especially damaging to the markets because they impose a dead-weight loss on investors. The Senate committee report prepared after the hearings on the PSLRA emphasized the cost of class-action litigation, noting that in 1994 corporations and their insurers paid $1.4 billion to settle various securities lawsuits. S. Rep. No. 104-98, 8-10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 683, 687-89. The average cost of settlement was $8.6 million. *Id.* More recent surveys report that settlement costs for all securities class-action suits have increased along with the length of the settlement process while the number of cases settling has decreased. *See* Mukesh Bajaj, Sumon C. Mazumdar, & Atulya Sarin, *Securities Class Action Settlements*, 43 Santa Clara L. Rev. 1001 (2003).

This Court has noted that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. The danger is not

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hyperlink; then follow February 2006 hyperlink) (last visited Nov. 11, 2005). The authors survey the securities regulations of 49 countries and find, among other things, a positive correlation between judicial efficiency and developed financial markets. They conclude that the benefits of regulation typical in common-law jurisdictions "lie in its emphasis on private contracting and standardized disclosure, and in its reliance on private dispute resolution using market-friendly standards of liability." *Id.* at 23.

ameliorated when suits resembling suits brought under Rule 10b-5 are brought in state court based on state blue sky laws or common law; rather, it is exacerbated. The PSLRA was a response to vexatious federal litigation, but its strictures do not apply in state court. The lack discovery stay and stringent pleading standards in state court proceedings adjudicating claims based on state fraud statutes increases both the cost of the litigation and the incentive to settle, regardless of the merits, to avoid those costs. Also, as illustrated by the present case, state law may provide expanded bases of liability for both individual and class action suits. This Court held in *Blue Chip Stamps* that sound policy dictated that the same claim asserted in *Dabit* could not proceed under Rule 10b-5. The policy arguments against allowing class-action lawsuits asserting the claim in federal court apply in state court. The costs of defending class actions are no less and the difficulties inherent in the holding claim itself are the same.

3. State Courts Recognize that Differences Between State and Federal Regulations Governing Securities Markets Create Costs and Impede Market Efficiency.

State courts recognize that state law can impede market efficiency and increase costs by imposing liability beyond that imposed by federal securities laws. For example, the SEC adopted a regulation to establish uniform practices regarding the payment for order flow. That rule allowed the payments subject to reasonable disclosure requirements. The SEC's less stringent standard conflicted with regulations in a number of states. Addressing that conflict, the New York Court of Appeals held that uniform national rule preempted New York's regulation because enforcing its more stringent standard would cause firms to cease payment for order flow despite the SEC's judgment the practice was beneficial to the

securities market. *Guice*, 674 N.E.2d at 289-91. At least four other states reached the same conclusion. *See McKey v. Charles Schwab & Co.*, 79 Cal. Rptr. 2d 213 (Cal. App. 1998); *Orman v. Charles Schwab & Co.*, 688 N.E.2d 620 (Ill. 1997); *Dahl*, 545 N.W.2d at 925-26; *Shulick v. PaineWebber, Inc.*, 722 A.2d 148 (Pa. 1998); *see also* Rutheford B. Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 Wash. U. L.Q. 407 (2000) (arguing that non-preempted state securities regulations applicable to small issuers increases their capital costs.).

CONCLUSION

The judgment of the Second Circuit should be reversed.

Respectfully submitted,

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Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.*, 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC. *v.* DABIT

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 04–1371. Argued January 18, 2006—Decided March 21, 2006

Respondent Dabit filed a private securities fraud class action in federal court, invoking diversity jurisdiction to advance his state-law claims that petitioner, his former employer, fraudulently manipulated stock prices, causing him and other brokers and their clients to keep their overvalued securities. The District Court dismissed his amended complaint, finding his claims pre-empted by title I of the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which provides that no "covered class action" based on state law and alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" "may be maintained in any State or Federal court by any private party." 15 U. S. C. §78bb(f)(1)(A). Vacating the judgment, the Second Circuit concluded that, to the extent the complaint alleged that brokers were fraudulently induced, not to sell or purchase, but to retain or delay selling, it fell outside SLUSA's pre-emptive scope.

Held: The background, text, and purpose of SLUSA's pre-emption provision demonstrate that SLUSA pre-empts state-law holder class-action claims of the kind Dabit alleges. Pp. 5–17.

(a) The magnitude of the federal interest in protecting the integrity and efficiency of the national securities market cannot be overstated. The Securities Act of 1933 and the Securities Exchange Act of 1934 (1934 Act) anchor federal regulation of vital elements of this Nation's economy. Securities and Exchange Commission (SEC) Rule 10b–5, which was promulgated pursuant to §10(b) of the 1934 Act, is an important part of that regulatory scheme, and, like §10(b), prohibits deception, misrepresentation, and fraud "in connection with the purchase or sale" of a security. When, in *Blue Chip Stamps* v. *Manor*

Drug Stores, 421 U. S. 723, this Court limited the Rule 10b–5 private right of action to plaintiffs who were themselves purchasers or sellers, it relied on the widespread recognition that suits by nonpurchasers and nonsellers present a special risk of vexatious litigation that could "frustrate or delay normal business activity," *id.*, at 740. Pp. 5–8.

(b) Similar policy considerations prompted Congress to adopt legislation (Reform Act) targeted at perceived abuses of class actions—*e.g.*, nuisance filings and vexatious discovery requests—but this effort prompted members of the plaintiffs' bar to avoid the federal forum altogether. To stem the shift of class actions from federal to state courts, Congress enacted SLUSA. Pp. 8–10.

(c) Both the class and the securities here are "covered" within SLUSA's meaning, and the complaint alleges misrepresentations and omissions of material facts. The only disputed issue is whether the alleged wrongdoing was "in connection with the purchase or sale" of securities. Dabit's narrow reading would pre-empt only those actions in which *Blue Chip Stamps'* purchaser-seller requirement is met. Insofar as that argument assumes that the *Blue Chip Stamps* rule stems from Rule 10b–5's text, it must be rejected, for the Court relied on "policy considerations" in adopting that limitation, and it purported to define the scope of a private right of action under Rule 10b–5, not to define "in connection with the purchase or sale." When this Court has sought to give meaning to that phrase in the §10(b) and Rule 10b–5 context, it has broadly required that the alleged fraud "coincide" with a securities transaction, an interpretation that comports with the SEC's longstanding views. Congress can hardly have been unaware of this broad construction when it imported the phrase into SLUSA. Where judicial interpretations have settled a statutory provision's meaning, repeating the same language in a new statute indicates the intent to incorporate the judicial interpretations as well. That presumption is particularly apt here, because Congress not only used §10(b)'s and Rule 10b–5's words, but used them in another provision appearing in the same statute as §10(b). The presumption that Congress envisioned a broad construction also follows from the particular concerns that culminated in SLUSA's enactment, viz., preventing state private securities class-action suits from frustrating the Reform Act's objectives. A narrow construction also would give rise to wasteful, duplicative litigation in state and federal courts. The presumption that "Congress does not cavalierly pre-empt state-law causes of action," *Medtronic, Inc.* v. *Lohr*, 518 U. S. 470, 485, has less force here because SLUSA does not pre-empt any cause of action. It simply denies the use of the class-action device to vindicate certain claims. Moreover, tailored exceptions to SLUSA's pre-

Syllabus

emptive command—for, *e.g.*, state agency enforcement proceedings—demonstrate that Congress did not act cavalierly. Finally, federal, not state, law has long been the principal vehicle for asserting class-action securities fraud claims. Pp. 10–16.

(d) Dabit's holder class action is distinguishable from a typical Rule 10b–5 class action only in that it is brought by holders rather than sellers or purchasers. That distinction is irrelevant for SLUSA pre-emption purposes. The plaintiffs' identity does not determine whether the complaint alleges the requisite fraud, and the alleged misconduct here—fraudulent manipulation of stock prices—unquestionably qualifies as a fraud "in connection with the purchase or sale" of securities as the phrase is defined in *SEC* v. *Zandford*, 535 U. S. 813, 820, and *United States* v. *O'Hagan*, 521 U. S. 642, 651. Pp. 16–17.

395 F. 3d 25, vacated and remanded.

STEVENS, J., delivered the opinion of the Court, in which all other Members joined, except ALITO, J., who took no part in the consideration or decision of the case.

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D. C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

No. 04–1371

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., PETITIONER *v.* SHADI DABIT

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

[March 21, 2006]

JUSTICE STEVENS delivered the opinion of the Court.

Title I of the Securities Litigation Uniform Standards Act of 1998 (SLUSA) provides that "[n]o covered class action" based on state law and alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" "may be maintained in any State or Federal court by any private party." §101(b), 112 Stat. 3227 (codified at 15 U. S. C. § 78bb(f)(1)(A)). In this case the Second Circuit held that SLUSA only pre-empts state-law class-action claims brought by plaintiffs who have a private remedy under federal law. 395 F. 3d 25 (2005). A few months later, the Seventh Circuit ruled to the contrary, holding that the statute also pre-empts state-law class-action claims for which federal law provides no private remedy. *Kircher* v. *Putnam Funds Trust*, 403 F. 3d 478 (2005). The background, the text, and the purpose of SLUSA's pre-emption provision all support the broader interpretation adopted by the Seventh Circuit.

I

Petitioner Merrill Lynch, Pierce, Fenner & Smith, Inc.

(Merrill Lynch), is an investment banking firm that offers research and brokerage services to investors. Suspicious that the firm's loyalties to its investment banking clients had produced biased investment advice, the New York attorney general in 2002 instituted a formal investigation into Merrill Lynch's practices. The investigation sparked a number of private securities fraud actions, this one among them.[1]

Respondent, Shadi Dabit, is a former Merrill Lynch broker. He filed this class action in the United States District Court for the Western District of Oklahoma on behalf of himself and all other former or current brokers who, while employed by Merrill Lynch, purchased (for themselves and for their clients) certain stocks between December 1, 1999, and December 31, 2000. See App. 27a–46a. Rather than rely on the federal securities laws, Dabit invoked the District Court's diversity jurisdiction and advanced his claims under Oklahoma state law.

The gist of Dabit's complaint was that Merrill Lynch breached the fiduciary duty and covenant of good faith and fair dealing it owed its brokers by disseminating misleading research and thereby manipulating stock prices.[2] Dabit's theory was that Merrill Lynch used its misinformed brokers to enhance the prices of its investment banking clients' stocks: The research analysts, under management's direction, allegedly issued overly optimistic appraisals of the stocks' value; the brokers allegedly relied on the analysts' reports in advising their investor clients

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[1] Merrill Lynch eventually settled its dispute with the New York attorney general.

[2] The complaint alleged, for example, that the prices of the subject stocks were "artificially inflated as a result of the manipulative efforts" of Merrill Lynch, and that Merrill Lynch, "acting as a central nerve center in the manipulation of various stocks . . . , perpetrated this stock manipulation through a variety of deceptive devices, artifices, and tactics that are the hallmarks of stock manipulation." App. 28a–29a.

and in deciding whether or not to sell their own holdings; and the clients and brokers both continued to hold their stocks long beyond the point when, had the truth been known, they would have sold. The complaint further alleged that when the truth was actually revealed (around the time the New York attorney general instituted his investigation), the stocks' prices plummeted.

Dabit asserted that Merrill Lynch's actions damaged the class members in two ways: The misrepresentations and manipulative tactics caused them to hold onto overvalued securities, and the brokers lost commission fees when their clients, now aware that they had made poor investments, took their business elsewhere.

In July 2002, Merrill Lynch moved to dismiss Dabit's complaint. It argued, first, that SLUSA pre-empted the action and, second, that the claims alleged were not cognizable under Oklahoma law. The District Court indicated that it was "not impressed by" the state-law argument, but agreed that the federal statute pre-empted at least some of Dabit's claims. *Id.*, at 49a–50a. The court noted that the complaint alleged both "claims and damages based on wrongfully-induced purchases" and "claims and damages based on wrongfully-induced holding." *Ibid.* While the "holding" claims, the court suggested, might not be pre-empted, the "purchasing" claims certainly were. The court dismissed the complaint with leave to amend to give Dabit the opportunity to untangle his "hopeless mélange of purchase-related and holding-related assertions." *Ibid.* (punctuation added).

Dabit promptly filed an amended complaint that omitted all direct references to purchases. What began as a class of brokers who "purchased" the subject securities during the class period became a class of brokers who "owned and continued to own" those securities. See *id.*, at 52a.

Meanwhile, dozens of other suits, based on allegations

similar to Dabit's, had been filed against Merrill Lynch around the country on both federal- and state-law theories of liability. The Judicial Panel on Multidistrict Litigation transferred all of those cases, along with this one, to the United States District Court for the Southern District of New York for consolidated pre' ial proceedings. Merrill Lynch then filed its second motion to dismiss Dabit's complaint. Senior Judge Milton Pollack granted the motion on the ground that the claims alleged fell "squarely within SLUSA's ambit." *In re Merrill Lynch & Co., Inc.*, 2003 WL 1872820, *1 (Apr. 10, 2003).

The Court of Appeals for the Second Circuit, however, vacated the judgment and remanded for further proceedings. 395 F. 3d, at 51. It concluded that the claims asserted by holders did not allege fraud "in connection with the purchase or sale" of securities under SLUSA. Although the court agreed with Merrill Lynch that that phrase, as used in other federal securities laws, has been defined broadly by this Court, it held that Congress nonetheless intended a narrower meaning here—one that incorporates the "standing" limitation on private federal securities actions adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723 (1975). Under the Second Circuit's analysis, fraud is only "in connection with the purchase or sale" of securities, as used in SLUSA, if it is alleged by a purchaser or seller of securities. Thus, to the extent that the complaint in this action alleged that brokers were fraudulently induced, not to sell or purchase, but to retain or delay selling their securities, it fell outside SLUSA's preemptive scope.[3]

After determining that the class defined in Dabit's

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[3]The Court of Appeals also concluded that Dabit's lost commission claims escaped pre-emption under SLUSA because they did not "allege fraud that 'coincide[s]' with the sale or purchase of a security." 395 F. 3d, at 47 (quoting *SEC* v. *Zandford*, 535 U. S. 813, 825 (2002)). That determination is not before this Court for review.

amended complaint did not necessarily exclude purchasers, the panel remanded with instructions that the pleading be dismissed without prejudice. The court's order would permit Dabit to file another amended complaint that defines the class to exclude "claimants who purchased in connection with the fraud and who therefore could meet the standing requirement" for a federal damages action, and to include only those "who came to hold [a Merrill Lynch] stock before any relevant misrepresentation." 395 F. 3d, at 45–46. Under the Second Circuit's analysis, a class action so limited could be sustained under state law. For the reasons that follow, we disagree.

II

The magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated. In response to the sudden and disastrous collapse in prices of listed stocks in 1929, and the Great Depression that followed, Congress enacted the Securities Act of 1933 (1933 Act), 48 Stat. 74, and the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 881. Since their enactment, these two statutes have anchored federal regulation of vital elements of our economy.

Securities and Exchange Commission (SEC) Rule 10b–5, 17 CFR §240.10b–5 (2005), promulgated in 1942 pursuant to §10(b) of the 1934 Act, 15 U. S. C. §78j(b), is an important part of that regulatory scheme. The Rule, like §10(b) itself,[4] broadly prohibits deception, misrepresentation, and

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[4]Section 10(b) provides as follows:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in

fraud "in connection with the purchase or sale of any security."[5] The SEC has express statutory authority to enforce the Rule. See 15 U. S. C. §78u (2000 ed. and Supp. III). Although no such authority is expressly granted to private individuals injured by securities fraud, in 1946 Judge Kirkpatrick of the United States District Court for the Eastern District of Pennsylvania, relying on "the general purpose" of the Rule, recognized an implied right of action thereunder. *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514. His holding was adopted by an "overwhelming consensus of the District Courts and Courts of Appeals," *Blue Chip Stamps*, 421 U. S., at 730, and endorsed by this Court in *Superintendent of Ins. of N. Y.* v. *Bankers Life & Casualty Co.*, 404 U. S. 6 (1971).

A few years after *Kardon* was decided, the Court of Appeals for the Second Circuit limited the reach of the private right of action under Rule 10b–5. In *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (1952), a panel composed of Chief Judge Swan and Judges Augustus and Learned Hand upheld the dismissal of a suit brought on behalf of a corporation and a class of its stockholders

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contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U. S. C. §78j(b).

[5]The text of the Rule is as follows:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security." 17 CFR §240.10b–5 (2005).

alleging that fraud "in connection with" a director's sale of his controlling block of stock to third parties violated Rule 10b–5. The court held that the Rule could only be invoked by a purchaser or seller of securities to remedy fraud associated with his or her own sale or purchase of securities, and did not protect those who neither purchased nor sold the securities in question but were instead injured by corporate insiders' sales to third parties. *Id.*, at 464. While the *Birnbaum* court did not question the plaintiffs' "standing" to enforce Rule 10b–5, later cases treated its holding as a standing requirement. See *Eason* v. *General Motors Acceptance Corp.*, 490 F. 2d 654, 657 (CA7 1973).

By the time this Court first confronted the question, literally hundreds of lower court decisions had accepted "*Birnbaum's* conclusion that the plaintiff class for purposes of §10(b) and Rule 10b–5 private damages actions is limited to purchasers and sellers." *Blue Chip Stamps*, 421 U. S., at 731–732. Meanwhile, however, cases like *Bankers Life & Casualty Co.* had interpreted the coverage of the Rule more broadly to prohibit, for example, "deceptive practices *touching* [a victim's] sale of securities as an investor." 404 U. S., at 12–13 (emphasis added); see *Eason*, 490 F. 2d, at 657 (collecting cases). The "judicial oak which ha[d] grown from little more than a legislative acorn," as then-Justice Rehnquist described the rules governing private Rule 10b–5 actions, *Blue Chip Stamps*, 421 U. S., at 737, had thus developed differently from the law defining what constituted a substantive violation of Rule 10b–5. Ultimately, the Court had to decide whether to permit private parties to sue for any violation of Rule 10b–5 that caused them harm, or instead to limit the private remedy to plaintiffs who were themselves purchasers or sellers.

Relying principally on "policy considerations" which the Court viewed as appropriate in explicating a judicially crafted remedy, *ibid.*, and following judicial precedent

rather than "the many commentators" who had criticized the *Birnbaum* rule as "an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages," 421 U. S., at 738, the Court in *Blue Chip Stamps* chose to limit the private remedy. The main policy consideration tipping the scales in favor of precedent was the widespread recognition that "litigation under Rule 10b–5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Id.*, at 739. Even weak cases brought under the Rule may have substantial settlement value, the Court explained, because "[t]he very pendency of the lawsuit may frustrate or delay normal business activity." *Id.*, at 740. Cabining the private cause of action by means of the purchaser-seller limitation would, in the Court's view, minimize these ill effects. The limitation of course had no application in Government enforcement actions brought pursuant to Rule 10b–5. See *id.*, at 751, n. 14.

III

Policy considerations similar to those that supported the Court's decision in *Blue Chip Stamps* prompted Congress, in 1995, to adopt legislation targeted at perceived abuses of the class-action vehicle in litigation involving nationally traded securities. While acknowledging that private securities litigation was "an indispensable tool with which defrauded investors can recover their losses," the House Conference Report accompanying what would later be enacted as the Private Securities Litigation Reform Act of 1995 (Reform Act), 109 Stat. 737 (codified at 15 U. S. C. §§77z–1 and 78u–4), identified ways in which the class action device was being used to injure "the entire U. S. economy." H. R. Rep. No. 104–369, p. 31 (1995). According to the Report, nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and "manipulation by class action lawyers of the clients whom

they purportedly represent" had become rampant in recent years. *Ibid.* Proponents of the Reform Act argued that these abuses resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors. *Id.*, at 31–32.

Title I of the Reform Act, captioned "Reduction of Abusive Litigation," represents Congress' effort to curb these perceived abuses. Its provisions limit recoverable damages and attorney's fees, provide a "safe harbor" for forward-looking statements, impose new restrictions on the selection of (and compensation awarded to) lead plaintiffs, mandate imposition of sanctions for frivolous litigation, and authorize a stay of discovery pending resolution of any motion to dismiss. See 15 U. S. C. §78u–4. Title I also imposes heightened pleading requirements in actions brought pursuant to §10(b) and Rule 10b–5; it "insists that securities fraud complaints 'specify' each misleading statement; that they set forth the facts 'on which [a] belief that a statement is misleading was 'formed'; and that they 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U. S. 336, 345 (2005) (quoting 15 U. S. C. §§78u–4(b)(1), (2)).

The effort to deter or at least quickly dispose of those suits whose nuisance value outweighs their merits placed special burdens on plaintiffs seeking to bring federal securities fraud class actions. But the effort also had an unintended consequence: It prompted at least some members of the plaintiffs' bar to avoid the federal forum altogether. Rather than face the obstacles set in their path by the Reform Act, plaintiffs and their representatives began bringing class actions under state law, often in state court. The evidence presented to Congress during a 1997 hearing to evaluate the effects of the Reform Act suggested that this phenomenon was a novel one; state-court litigation of

class actions involving nationally traded securities had previously been rare. See H. R. Rep. No. 105–640, p. 10 (1998); S. Rep. No. 105–182, pp. 3–4 (1998). To stem this "shif[t] from Federal to State courts" and "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of" the Reform Act, SLUSA §§2(2), (5), 112 Stat. 3227, Congress enacted SLUSA.

IV

The core provision of SLUSA reads as follows:[6]

> "CLASS ACTION LIMITATIONS.—No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> "(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> "(B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." *Id.*, at 3230 (codified as amended at 15 U. S. C. §78bb(f)(1)).[7]

A "covered class action" is a lawsuit in which damages are sought on behalf of more than 50 people.[8] A "covered

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[6] SLUSA amends the 1933 Act and the 1934 Act in substantially identical ways. For convenience and because they are more pertinent here, we quote the amendments to the 1934 Act.

[7] Another key provision of the statute makes all "covered class actions" filed in state court removable to federal court. 112 Stat. 3230 (codified at 15 U. S. C. §78bb(f)(2)).

[8] "The term 'covered class action' means—

"(i) any single lawsuit in which—

"(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission,

security" is one traded nationally and listed on a regulated national exchange.[9] Respondent does not dispute that both the class and the securities at issue in this case are "covered" within the meaning of the statute, or that the complaint alleges misrepresentations and omissions of material facts. The only disputed issue is whether the alleged wrongdoing was "in connection with the purchase or sale" of securities.

Respondent urges that the operative language must be read narrowly to encompass (and therefore pre-empt) only those actions in which the purchaser-seller requirement of *Blue Chip Stamps* is met. Such, too, was the Second Circuit's view. But insofar as the argument assumes that the rule adopted in *Blue Chip Stamps* stems from the text of Rule 10b–5—specifically, the "in connection with" language, it must be rejected. Unlike the *Birnbaum* court, which relied on Rule 10b–5's text in crafting its purchaser-seller limitation, this Court in *Blue Chip Stamps* relied

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predominate over any questions affecting only individual persons or members; or

"(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

"(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

"(I) damages are sought on behalf of more than 50 persons; and

"(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose." 112 Stat. 3232 (codified at 15 U. S. C. §78bb(f)(5)(B)).

[9] "The term 'covered security' means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933, at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred. . . ." 112 Stat. 3232 (codified at 15 U. S. C. §78bb(f)(5)(E)). Section 18(b) of the 1933 Act in turn defines "covered security" to include securities traded on a national exchange. §77r(b).

chiefly, and candidly, on "policy considerations" in adopting that limitation. 421 U. S., at 737. The *Blue Chip Stamps* Court purported to define the scope of a private right of action under Rule 10b–5—not to define the words "in connection with the purchase or sale." *Id.*, at 749 ("No language in either [§10(b) or Rule 10b–5] speaks at all to the contours of a private cause of action for their violation"). Any ambiguity on that score had long been resolved by the time Congress enacted SLUSA. See *United States* v. *O'Hagan*, 521 U. S. 642, 656, 664 (1997); *Holmes* v. *Securities Investor Protection Corporation*, 503 U. S. 258, 285 (1992) (O'Connor, J., concurring in part and concurring in judgment); *id.*, at 289–290 (SCALIA, J., concurring in judgment); *United States* v. *Naftalin*, 441 U. S. 768, 774, n. 6 (1979); see also 395 F. 3d, at 39 (acknowledging that "[t]he limitation on standing to bring [a] private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities").

Moreover, when this Court *has* sought to give meaning to the phrase in the context of §10(b) and Rule 10b–5, it has espoused a broad interpretation. A narrow construction would not, as a matter of first impression, have been unreasonable; one might have concluded that an alleged fraud is "in connection with" a purchase or sale of securities only when the plaintiff himself was defrauded into purchasing or selling particular securities. After all, that was the interpretation adopted by the panel in the *Birnbaum* case. See 193 F. 2d, at 464. But this Court, in early cases like *Superintendent of Ins. of N. Y.* v. *Bankers Life & Casualty Co.*, 404 U. S. 6 (1971), and most recently in *SEC* v. *Zandford*, 535 U. S. 813, 820, 822 (2002), has rejected that view. Under our precedents, it is enough that the fraud alleged "coincide" with a securities transaction—

whether by the plaintiff or by someone else. See *O'Hagan*, 521 U. S., at 651. The requisite showing, in other words, is "deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller." *Id.*, at 658. Notably, this broader interpretation of the statutory language comports with the longstanding views of the SEC. See *Zandford*, 535 U. S., at 819–820.[10]

Congress can hardly have been unaware of the broad construction adopted by both this Court and the SEC when it imported the key phrase—"in connection with the purchase or sale"—into SLUSA's core provision. And when "judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon* v. *Abbott*, 524 U. S. 624, 645 (1998); see *Cannon* v. *University of Chicago*, 441 U. S. 677, 696–699 (1979). Application of that presumption is particularly apt here; not only did Congress use the same words as are used in §10(b) and Rule 10b–5, but it used them in a provision that appears in the same statute as §10(b). Generally, "identical words used in different parts of the same statute are . . . presumed to have the same meaning." *IBP, Inc.* v. *Alvarez*, 546 U. S. __, __ (2005) (slip op., at 11).

The presumption that Congress envisioned a broad construction follows not only from ordinary principles of statutory construction but also from the particular concerns that culminated in SLUSA's enactment. A narrow reading of the statute would undercut the effectiveness of the 1995 Reform Act and thus run contrary to SLUSA's

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[10] In *Zandford*, we observed that the SEC has consistently "maintained that a broker who accepts payment for securities that he never intends to deliver, or who sells customer securities with intent to misappropriate the proceeds, violates §10(b) and Rule 10b–5." 535 U. S., at 819. Here, too, the SEC supports a broad reading of the "in connection with" language.

stated purpose, viz., "to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives" of the 1995 Act. SLUSA §2(5), 112 Stat. 3227. As the *Blue Chip Stamps* Court observed, class actions brought by holders pose a special risk of vexatious litigation. 421 U. S., at 739. It would be odd, to say the least, if SLUSA exempted that particularly troublesome subset of class actions from its pre-emptive sweep. See *Kircher*, 403 F. 3d, at 484.

Respondent's preferred construction also would give rise to wasteful, duplicative litigation. Facts supporting an action by purchasers under Rule 10b–5 (which must proceed in federal court if at all) typically support an action by holders as well, at least in those States that recognize holder claims. The prospect is raised, then, of parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts. That prospect, which exists to some extent in this very case,[11] squarely conflicts with the congressional preference for "national standards for securities class action lawsuits involving nationally traded securities." SLUSA §2(5), 112 Stat. 3227.[12]

In concluding that SLUSA pre-empts state-law holder class-action claims of the kind alleged in Dabit's complaint, we do not lose sight of the general "presum[ption] that Congress does not cavalierly pre-empt state-law causes of action." *Medtronic, Inc.* v. *Lohr*, 518 U. S. 470,

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[11] See 2003 WL 1872820, *1 (SDNY, Apr. 10, 2003) (observing that Dabit's holder claims rested "on the very same alleged series of transactions and occurrences asserted in the federal securities actions" filed against Merrill Lynch).

[12] See H. R. Rep. No. 105–640, p. 10 (1998) (the "solution" to circumvention of the Reform Act "is to make Federal court the exclusive venue for securities fraud class action litigation"); S. Rep. No. 105–182, p. 3 (1998) (identifying "the danger of maintaining differing federal and state standards of liability for nationally-traded securities").

485 (1996). But that presumption carries less force here than in other contexts because SLUSA does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class action device to vindicate certain claims. The Act does not deny any individual plaintiff, or indeed any group of fewer than 50 plaintiffs, the right to enforce any state-law cause of action that may exist.

Moreover, the tailored exceptions to SLUSA's pre-emptive command demonstrate that Congress did not by any means act "cavalierly" here. The statute carefully exempts from its operation certain class actions based on the law of the State in which the issuer of the covered security is incorporated, actions brought by a state agency or state pension plan, actions under contracts between issuers and indenture trustees, and derivative actions brought by shareholders on behalf of a corporation. 15 U. S. C. §§78bb(f)(3)(A)–(C), (f)(5)(C). The statute also expressly preserves state jurisdiction over state agency enforcement proceedings. §78bb(f)(4). The existence of these carve-outs both evinces congressional sensitivity to state prerogatives in this field and makes it inappropriate for courts to create additional, implied exceptions.

Finally, federal law, not state law, has long been the principal vehicle for asserting class-action securities fraud claims. See, *e.g.*, H. R. Conf. Rep. No. 105–803, p. 14 (1998) ("Prior to the passage of the Reform Act, there was essentially no significant securities class action litigation brought in State court").[13] More importantly, while state-

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[13] Respondent points out that the Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723 (1975), identified as a factor mitigating any unfairness caused by adoption of the purchaser-seller requirement that "remedies are available to nonpurchasers and nonsellers under state law." *Id.*, at 738, n. 9. He argues that this supports a narrow construction of SLUSA's pre-emption provision. But we do not here revisit the *Blue Chip Stamps* Court's understanding of the equities

law holder claims were theoretically available both before and after the decision in *Blue Chip Stamps*, the actual assertion of such claims by way of class action was virtually unheard of before SLUSA was enacted; respondent and his *amici* have identified only *one* pre-SLUSA case involving a state-law class action asserting holder claims.[14] This is hardly a situation, then, in which a federal statute has eliminated a historically entrenched state-law remedy. Cf. *Bates* v. *Dow Agrosciences LLC*, 544 U. S. 431, 449 (2005) (observing that a "long history" of state-law tort remedy "add[ed] force" to the presumption against pre-emption).

V

The holder class action that respondent tried to plead, and that the Second Circuit envisioned, is distinguishable from a typical Rule 10b–5 class action in only one respect: It is brought by holders instead of purchasers or sellers. For purposes of SLUSA pre-emption, that distinction is irrelevant; the identity of the plaintiffs does not determine whether the complaint alleges fraud "in connection with the purchase or sale" of securities. The misconduct of which respondent complains here—fraudulent manipulation of stock prices—unquestionably qualifies as fraud "in connection with the purchase or sale" of securities as the phrase is defined in *Zandford*, 535 U. S., at 820, 822, and *O'Hagan*, 521 U. S., at 651.

The judgment of the Court of Appeals for the Second Circuit is vacated, and the case is remanded for further

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involved in limiting the availability of private remedies under federal law; we are concerned instead with Congress' intent in adopting a pre-emption provision, the evident purpose of which is to limit the availability of remedies under state law.

[14] See Brief for Respondent 5 (citing *Weinberger* v. *Kendrick*, 698 F. 2d 61, 78 (CA2 1982) (approving a settlement that included holder claims brought pursuant to New York law)); see also Tr. of Oral Arg. 34–35.

proceedings consistent with this opinion.

It is so ordered.

JUSTICE ALITO took no part in the consideration or decision of this case.